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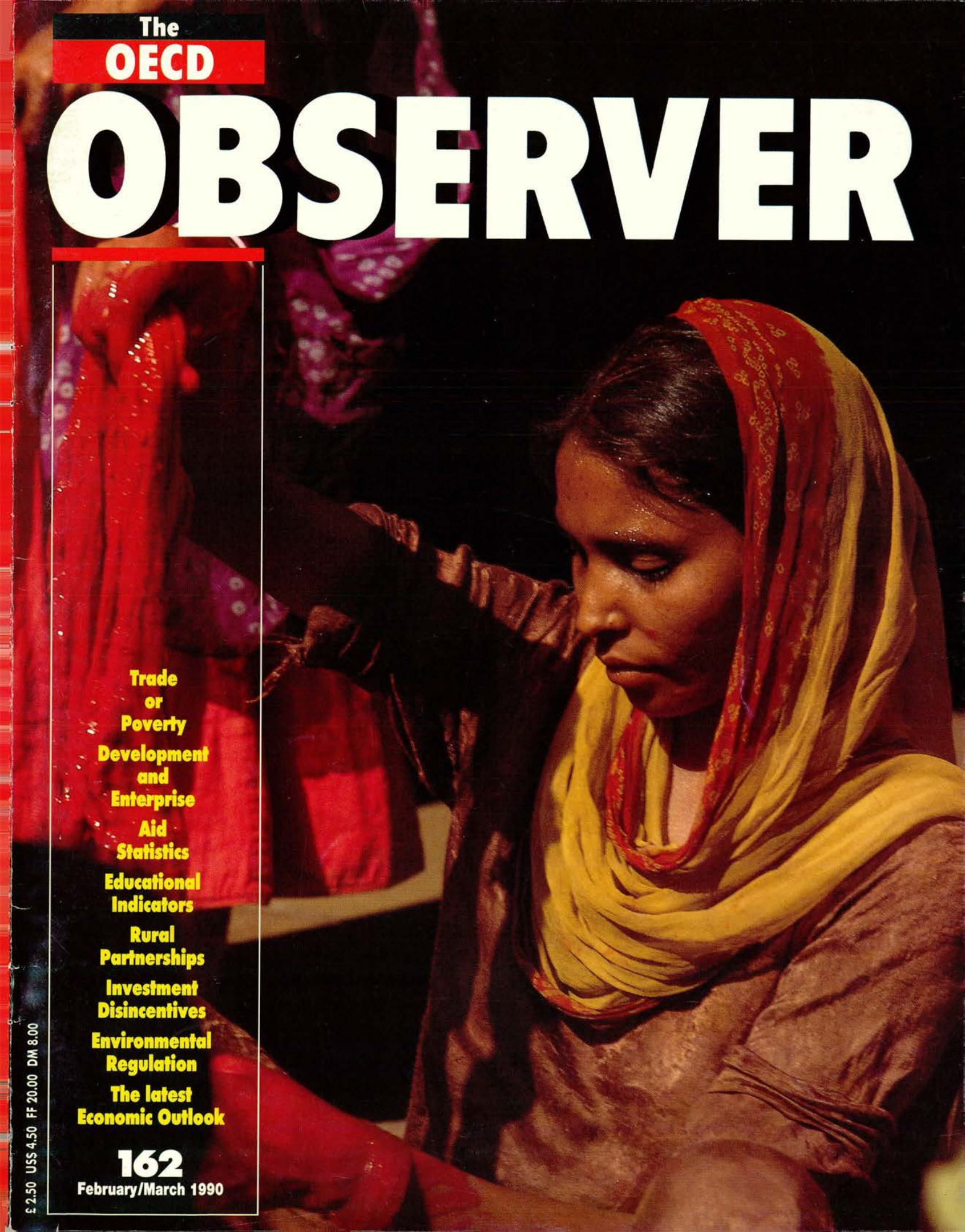

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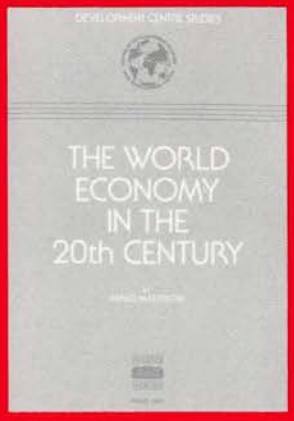

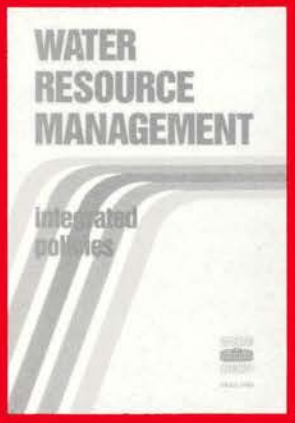

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J.F. Hurpré/AAA

Small-scale agriculture and enterprise offer the populations of developing countries a means of raising themselves out of poverty–a means which misguided trade policies have often denied them.

More Trade,

Christian Morrisson

Misguided trade policies in developing countries can worsen the poverty often endemic there and prevent peasant farmers and other small-scale producers from raising living standards.

A wide range of case studies, conducted in different regions, has highlighted the role played by imports and exports in determining the situation of the poor in developing countries, who in many cases constitute half the population.

The experience of some ten African countries, four of which (Ghana, Madagascar, Mozambique and Tanzania) were studied in depth,[1] provides a clear example. These four countries, poor and under-industrialised, have ruined their commercial agriculture by misguided import policies. The same process has been repeated in all of them: largely dependent on imports for their supply of agricultural inputs (fertilisers, pesticides, tools) and consumer goods (clothing, fabrics, shoes, soap, bicycles, and so on), their governments cut back on these imports in the 1960s and '70s, reserving foreign exchange for the purchase of the capital goods that industry required. They simultaneously imposed tight controls on agricultural exports, nationalising import-export trade and the collection of agricultural products, for which, in addition, they set very low prices.

The state thus broke the traditional link between imports of consumer goods and farm inputs and exports of agricultural products. As a result, discouraged peasant farmers reverted to subsistence farming. Why bother to grow cash crops if the consumer goods one requires can no longer be obtained? As might be expected, the shortage of farming inputs has led to a fall in output. Commercial farming is now in crisis. Production has fallen over the last ten years by between 30% and 90% depending on each case, with Ghana, whose cocoa production has fallen by 60%, representing the average.

Lower production has not only resulted in lower exports but, since farmers have reduced the quantity of food crops grown for the domestic market, has also made it necessary to import foodstuffs to meet urban requirements. The result is self-evident: a shortage of foreign exchange. The decline in cash crops (for export or domestic urban supplies) has substantially reduced the real income of peasant farmers or workers, sometimes by as much as half. The return to subsistence farming effectively pauperises the rural community, since non-food consumption is reduced to half or a quarter of its previous volume.

The impact of this misguided policy is not confined to the countryside or the farming sector. Shortage of foreign exchange has undermined the transport system, energy supplies and the supply of intermediate products for industry, where output has fallen to half, or even a quarter, of production capacity. The agricultural crisis has thus extended to the entire economy and the fall in living standards and the spread of poverty have now started to affect the urban population.

What Hope for Progress?

Is there a way out of this situation? How can the commercial farming of these countries be re-established? Raising agricultural prices is no solution: in an economy crippled by shortages, such a rise would not increase production, and might even reduce it. If cash requirements are frozen because of shortages, production may fall as prices rise.

The only solution is to re-establish the flow of imports and thus restock rural areas with imported manufactured goods. This is being done successfully in Mozambique by the Caisse Centrale de Coopération Economique (the French body responsible for loans to developing countries). It has also successfully relaunched cashew and cotton production by selling farmers fabrics, shoes, soap and other consumer goods which they buy with the money from their cash crops. In Ghana, cocoa production has increased strongly since the agency collecting the cocoa started to provide farmers with basic manufactured goods.

Christian Morrisson is Head of Programme in the OECD Development Centre.

1. J.C. Berthélemy and C. Morrisson, **Agricultural Development in Africa and the Supply of Manufactured Goods,** Development Centre/OECD Publications, 1989.

2. F. Bourguignon and C. Morrisson, **External Trade and Income Distribution,** Development Centre/OECD Publications, 1989.

3. A comparison of wages in the modernised sector, where income is higher, would not be relevant, since small farmers could never hope to enter it.

Bernhard Moosbrugger/Rapho

Less Poverty

It is clear, therefore, that if the developed world wishes to combat poverty in the crisis-ridden African countries, it must help to revive commercial agriculture there by financing imports of consumer goods and farming inputs. A major effort will be necessary, but it does not have to be a long one. After three or four years the farmers could themselves finance, through their exports, the purchase of the manufactured goods their farms and families require.

Yet to impose, from the outside, a tough regime of import cutbacks on these heavily indebted countries so as to reduce their trade-balance deficit is to condemn their agriculture to stagnation and to prolong the impoverishment of their peasant farmers.

Exports from developing countries affect poverty. Some, admittedly, have no impact on poor households, one example being exports from the large plantations: when these plantations offer rock-bottom wages to workers recruited from the under-developed traditional agricultural sector, it will hardly raise their standard of living.

But in several cases, exports have a decisive impact on the standard of living of the poor, as is confirmed by the study of exports in six countries (Costa Rica, Malawi, Malaysia, Morocco, Peru and Taiwan).[2] In all countries where the ownership of agricultural land is widely distributed, export crops offer considerably increased income for peasant farmers. In Costa Rica, Malawi or Malaysia, for example, small-scale farmers working for export enjoy an income 50, 100 or even 200% higher than those living in a subsistence economy. Malaysia is a classic example: in the 1970s, 90% of palm oil producers lived above the poverty threshold, while most subsistence farmers were below it.[3]

Alain Pinoges/CIRIC

Any increase in exports of labour-intensive manufactured goods has a substantial impact on poverty in the urban areas. This claim might seem paradoxical given the low wages paid in these industries, but such earnings are still generally higher than the income of the poor–farm workers, subsistence farmers, 'informal sector' workers outside the official economy–despite the different cost of living in town and country. Furthermore, these industries create many jobs and recruit the urban unemployed or the most disadvantaged rural inhabitants (underemployed workers or landless peasants), thus helping to reduce the labour surplus.

These beneficial effects are often wrongly understood. The wages paid in export industries are compared with the other wages in the modern sector, and it is true that officials, employees in some industries and in banking enjoy a markedly higher standard of living. But it is also an inescapable fact that in most countries half the labour force has a lower income than workers in export industries.

In the long term recruitment by export industries has a decisive effect on poverty. When the pool of unemployed or partially-unemployed people in the informal sector has been exhausted, export firms are forced to pay much higher wages. This is what happened in Taiwan in the 1970s when, the pool of manpower having dried up, the average wage increased more rapidly than productivity, and unskilled workers' wages increased much more swiftly than managerial earnings. This has two consequences: less inequality and a rapid reduction in poverty.

The undeniable conclusion is that the countries of the developed world cannot claim to be trying to combat poverty in developing countries and at the same time close their borders to exports which have a major impact on it. Yet that impact should be the *sine qua non* for opening borders. When export industries in some countries pay women and children rock-bottom wages well below the income of a small farmer or craftsman, they are not helping to reduce poverty. Laws banning child labour or introducing a minimum wage equivalent to at least twice the national per capita income would guarantee the reduction of poverty which can and should be expected from labour-intensive exports (and such a minimum wage would be so low that it would not damage marginal businesses).

Häusser/BASF

Likewise, when industrialised countries provide assistance (loans or grants) for developing export crops, they should bear in mind the impact on poverty. Priority must be given to the creation or extension of a class of small farmers. In export farming this type of structure has the fundamental advantage of improving the lot of a large number of peasants who previously lived in a subsistence economy. And where large plantations are dominant, assistance should be linked to the gradual development of farming structures that encourage small and medium-sized farms.

□ □

Combating poverty is not only a matter of humanitarian aid or grants, as these studies demonstrate. Appropriate measures in the context of normal trade relations can bring about a sustained improvement in the lot of the poor in developing countries. The famous phrase 'Trade, not aid' is important here, too, even if its meaning is sometimes obscured because it calls into question acquired positions in both developing and developed countries. ■

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Development through Enterprise

Cory Highland

The debate on development is shifting: donors and recipients of aid are now asking how the private sector can help developing countries reach their potential.[1]

In the 1990s the pattern of development will take a new turn: aid donors and recipients who before relied mostly on governments for growth will try to give business a more prominent role. Developing countries that moved ahead in the 1980s–or at least avoided serious deterioration–did so with essentially market-based economies. Private enterprise helped catalyse broad-based development.

Yet developing countries trying to give business a more prominent place in their economies often lack the fundamentals for market-led growth: basic education and training, physical and financial infrastructure, entrepreneurial skills and traditions, and policies that are compatible with business. OECD donors are therefore trying to address these requirements through support for the policies and institutions that will accelerate the growth of competitive enterprise and exports.

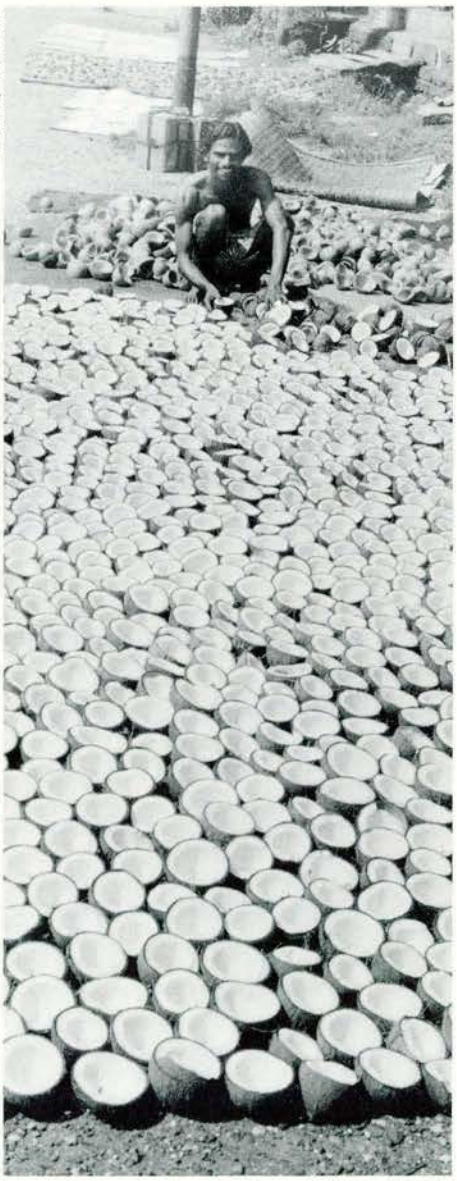
Institutional, Regulatory and Policy Adjustment

Policy reform has become a central concern. Sound economic policies are as essential for the success of enterprises and investments as for economic growth in general. Donor programmes for investment and export promotion, the privatisation of state-owned enterprises and assistance to local enterprises will falter or fail if the policy framework is wrong. Some donors are supporting adjustment programmes to establish–often for the first time–price structures in developing countries which reflect relative scarcities of labour, capital and foreign exchange. Not only does this promote growth, but the evidence shows that the distribution of income under these conditions is more equitable than in highly regulated economies.

Having assisted in building the road, rail and port systems that businessmen require to obtain inputs and to market their products, donors are being asked by some developing partners to help roll back the restrictive laws and practices which frustrate entrepreneurial growth. This task is often undertaken in collaboration with the World Bank, with the aim of minimising the costs of reform.

In Mali, for example, a multi-donor effort helped liberalise the cereals market, reduce consumer subsidies, and improve producer incentives. Private operators now participate in grain production and marketing.

In Indonesia, the World Bank, IMF and several OECD donors assisted in adjusting exchange rates, abolishing many import monopolies, reducing licensing burdens, and simplifying investment rules. Non-oil exports increased, the current-account deficit was halved, and local and foreign investment rose.



José Mayans/CIRIC

Micro-enterprises have a role to play in development.

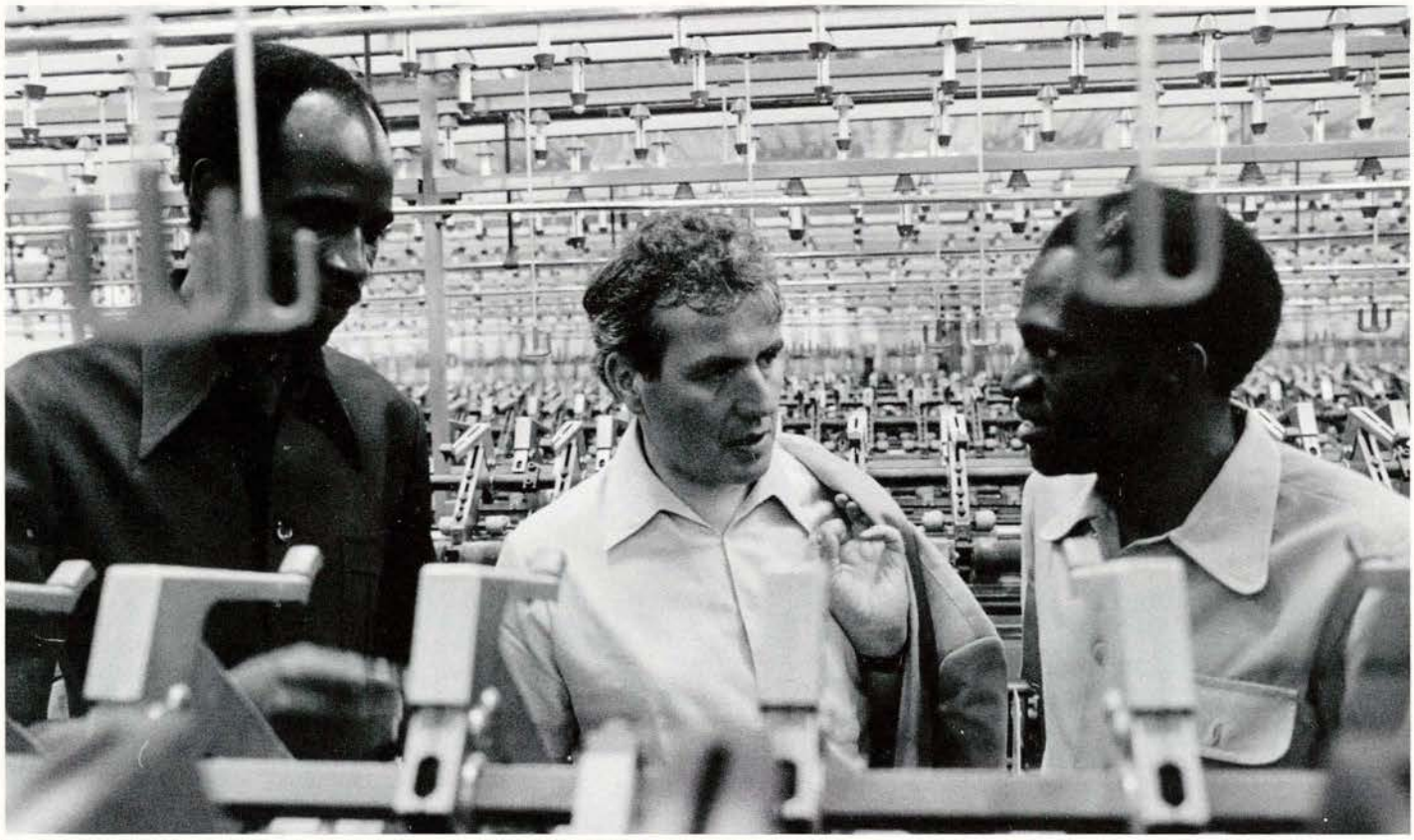
Making Capital Available

Commercial credit in many developing countries is expensive, difficult to obtain, or simply unavailable by legal means. Credit is limited by exchange-allocation systems which give government enterprises first claim on scarce financial resources, and by policies and regulations that discourage equity savings. In addition to encouraging reform of the financial sector to address these problems, external aid agencies have helped move credit to the private sector through local development banks, by opening up credit lines in central banks for 'on-lending' by local intermediaries to local customers, and by supporting institutions that provide financial services to small and medium-sized enterprises.

Germany, the Netherlands and Sweden

Cory Highland is an economist in the OECD Development Co-operation Directorate.

1. **International Co-operation for Private Enterprise and Investment in Developing Countries,** OECD Publications, Paris, forthcoming 1990.



Bundesbildstelle, Bonn

Some industrialised countries are offering training to businesses in developing countries.

are supporting partnerships between their commercial banks and banks in developing countries which specialise in small-scale lending. These programmes are designed to make credit available to small entrepreneurs, farmers and agro-businessmen who normally have little access to formal credit. Japan and other countries provide cheap loans for joint ventures, although some OECD donors regard this more as commercial than development support. A number of OECD donors are providing financial support to local enterprises through development banks.

The International Finance Corporation has taken the lead in developing financial markets, helping over 70 governments with tax laws, financial regulations and investor-protection policies. The IFC helped write India's securities law, train its stock-exchange manager, computerise the exchange, and establish a rating agency. It has also advised and invested in some 67 specialised financial institutions–brokerage and money-market houses, investment banks, leasing and insurance companies–in 34 developing countries.

Training and Technical Assistance

Business competitiveness depends on economic opportunity, and structural adjustments have created new possibilities for firms in a number of developing countries. Devaluation has made exporting more profitable, trade liberalisation has made it easier to import parts and export products, and deregulation has opened up sectors to private enterprises. Yet though better policies and more money are important, they alone will not enable LDC enterprises to make their full contribution to development. These businesses require technical, managerial and marketing skills if they are to raise productivity, diversify and expand. Donors are training local managers, assisting in technology transfer and financing feasibility studies and market surveys for local firms.

France, the United States and Germany, for example, fund feasibility studies; Switzerland and Canada support vocational training programmes; and the Netherlands finances in-plant training for LDC managers. In Costa Rica, the United States has trained businessmen, finance officials and academics in areas such as marketing, product management and export promotion. Managers, engineers and senior technicians from Pakistan, Malaysia and elsewhere are expanding their skills in a German training programme.

Programmes for Micro-enterprises

Micro-enterprises (MEs) play a central role in the economies of many developing countries. They typically consist of three

or four people–often family members–who engage in a wide variety of productive activities, including agriculture, handicrafts, trading, service and manufacturing. MEs are usually competitive in a limited range of goods and, although they are not necessarily more labour-intensive nor more efficient than larger firms, they are often the only alternative in an over-regulated economy. MEs require little capital and can rapidly adjust their output to local demand. With more credit and training they could play a bigger role in development.

Small, private, local lenders exerting community pressure on defaulters lend successfully to MEs in a number of developing countries. The Grameen Bank in Bangladesh, for example, has helped over 275,000 villagers start 500 different types of businesses by providing them with loans averaging $60. Grameen's repayment rate is 98%, and the Bank runs at a profit. Similar banks are being tried in Rwanda, Egypt, Kenya and Sudan. In Honduras private lenders to small groups making cheese, paper and brooms enjoy an 85–90% repayment rate.

Donors support these kinds of programmes through training, services, and credit for community-based co-operatives, private organisations and credit unions. In the Dominican Republic, the United States supports a private foundation that makes loans to small businesses. Germany has provided training, on-the-spot advice and support to Nepalese entrepreneurs. And France has helped establish local companies in Chile and Morocco which invest and lend to small enterprises.

Promoting Exports

The extent to which export promotion succeeds depends largely on the policies pursued. Inward-looking, import-substituting and protectionist policies, overvalued exchange rates and import and administrative restrictions must be changed if the export position of a country is to improve. Successful export promotion programmes have focused on removing these constraints and on improving infrastructure and assisting businesses capable of exporting.[2]

The World Bank and IMF have taken the lead in policy reform, with donors generally providing technical and institutional assistance and, increasingly, import financing to facilitate orderly liberalisation. These efforts have helped developing countries expand and diversify their exports.

In Thailand, for example, donors supported a World Bank effort to reduce taxes on agricultural exports, eliminate export restrictions and strengthen export incentives. Canada provides practical assistance in trade promotion, Finland runs export training courses and seminars, and the United Kingdom underwrites training courses and visits for developing-country trade officials. The United States has sponsored experts in the Dominican Republic who helped promote non-traditional exports such as electronics and pharmaceuticals by providing technical assistance to businesses there. Japan helps developing-country exporters adapt their products to the design and quality preferences of the Japanese market. A number of OECD donors and the EEC have programmes under which developing-country products can enter their markets duty-free.

Assistance for Privatisation

Government enterprises in many developing countries are suffering chronic losses from poor management, overstaffing and unclear or contradictory policies. Some aid agencies are helping to rationalise these ailing enterprises through technical and management advice, bridging finance, training support and policy and programme assistance. Pricing policies, subsidies and restrictive investment laws must be changed if privatisation is to succeed, but these reforms have been made difficult by the same political and economic obstacles that debilitated many state enterprises in the first place.

Nevertheless, a number of developing countries, assisted by the World Bank, IMF and several bilateral donors, are rationalising their public enterprises and looking to the private sector to fill the gap. Even 'public services' like agricultural marketing, health care and urban transport are now being undertaken by private operators in some developing countries.

In Brazil and Argentina, for example, external agencies played a part in privatising road construction and maintenance, and in Kenya private drivers compete freely with the state bus company. The United States helped Costa Rica reduce its public deficit by privatising or liquidating most of the subsidiaries of the state holding company, and Jamaica divested its shares in a major state bank with assistance from the United States. In Ghana, some water and sewerage services are privately provided, and several OECD donors are participating in a World Bank programme to transfer fertiliser distribu-

The improvement of infrastructure is often part and parcel of programmes to encourage exports.

Asian Development Bank

2. See pp. 4-6.

tion and tractor leasing to private companies. France provides bridging finance, training, and advisory services to governments requesting assistance in rationalising or privatising state companies.

Foreign Direct Investment

More and more developing countries are coming to realise that foreign direct investment brings capital, management expertise and technology if other supporting policies and institutions are in place.[3] Indeed, the possibilities for foreign private investment increase as business prospects in developing countries improve. The conditions required for local businesses to grow are largely the same ones that will attract foreign investors.

OECD donors are trying to encourage investment in developing countries through investment guarantee schemes, incentives for joint ventures, bilateral investment treaties, information and promotion services, and other means. Germany has signed bilateral investment treaties with 60 developing countries which provide for unrestricted transfer of capital and earnings, fair and equitable treatment and dispute settlement.

Nearly all OECD donors have investment guarantee schemes to protect investors against non-commercial risks such as war, political upheaval and expropriation, and most of them have agreements with developing countries to avoid double taxation. A number of OECD donors have established public finance corporations which act as both investment bank and development agency, and can exert leverage in mobilising foreign and local capital. And the newly established Multilateral Investment Guarantee Agency of the World Bank Group helps developing countries attract investment by insuring against these non-commercial risks; it also advises governments on programmes to facilitate foreign investment.

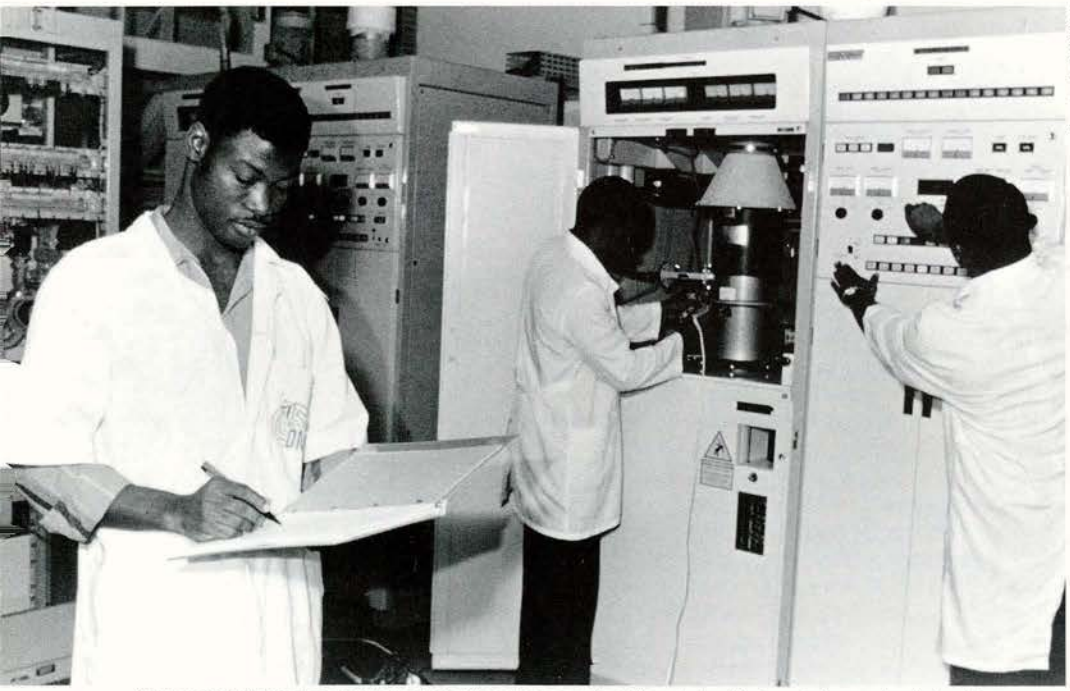
3. See pp. 23-27.

G. Boutin/Explorer

The International Finance Corporation has helped India computerise its stock exchange.

□ □

The recent emphasis on private enterprise is based on numerous country experiences in which businesses competing in open markets have catalysed development throughout the economy. Increasingly, donors and developing countries are recognising the importance of expanding the role of the private sector in development. The problems that stunt development often frustrate private enterprises. Aid donors are trying to help partner governments overcome these problems, with a view towards creating jobs, generating exports and increasing investment–which can only improve the conditions of life, income and employment for people in developing countries. ■



Renato Assis/REA

Some developing countries are in the process of rationalising their public-sector industries, sometimes even privatising them.

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Calculating Aid

Bevan Stein

'ODA% of GNP', 'TC to LLDCs', 'LMIC/UMIC': abbreviations of this kind bestrew the literature on development co-operation. How are the figures that underlie them collected? How are they processed, to provide data documenting the extent to which the economically advanced countries, and, more particularly, the members of the OECD Development Assistance Committee (DAC), contribute to the development efforts of the less prosperous countries of the world?

Statistics on aid and other resource flows to developing countries have been collected since the early 1960s. They were intended, then as now, to meet the requirements of policy-makers in development co-operation, and to assess the comparative performance of aid donors. They are at the heart of the periodic review of each donor's aid policies and programmes, one of the central functions of the DAC; and it has been recognised since the earliest days that they are indispensable ingredients of virtually every analysis of development and development co-operation.

Their uses extend further, into some perhaps unexpected areas. For example, prudently invested resources will generate exports or save imports. The data help policy-makers and others to understand aspects of the trade flows and trade policies of both donor and recipient countries which would otherwise escape analysis. The link with business is even clearer in the case of tied and partially untied aid, which in recent years account for over 50% of all bilateral Official Development Assistance (ODA) commitments.

Another extension is into the analysis of debt. Most ODA takes the form of grants. But there are also ODA loans. They have an average interest rate of under 3%, and an average maturity of almost 30 years. Servicing them is not costly, but it can exacerbate a country's existing debt problems. More technically, some ODA is used to relieve non-ODA debt, and the data on loans and grants for this purpose are indispensable for a full picture of the measures taken to alleviate the strain of debt on a borrowing country's economy.

Bevan Stein is Head of the Reporting Systems Division of the OECD Development Co-operation Directorate.

Data reach the OECD Secretariat in two related reporting systems. One is the so-called 'aggregate' DAC statistics–a set of 50 pages of statistical data in ten tables compiled annually by each of the 18 DAC member countries[1] and the EEC. In the other, the 'Creditor Reporting System', information is supplied continuously on each individual financial transaction between the official sector of a donor country and a public or private entity in the recipient country, together with data on officially guaranteed private export credits; these are reported individually if their maturity exceeds five years, and otherwise in aggregate. The OECD Secretariat processes approximately 10,000 reports a year on new individual transactions. The catalogue of 'live' transactions is of the order of 300,000.

Definitions and Comparability

The interest of reporting countries in these statistics is evidenced less by the size of the OECD staff engaged in tabulating, processing and analysing it (14 in all) than by the small army of statisticians in national capitals who collect data from the individual sources, compile them and send the returns to the OECD. They arrive in Paris in standardised form, tabulated following standardised definitions so that the data for each reporting country are fully comparable.

Without comparability, the statistics would be of limited value. Considerable attention is lavished on the dual aim of collecting data that are to the point (and no more than that), and ensuring that they are measured in the same way by different countries. Some aspects of this are self-evident: use of a common currency unit (the US dollar in this instance) converted from the reporting country currencies using the same convention (average rate for the year, and not a fixed–and in all likelihood different–date for each country); and use of the calendar year (and not the budget or fiscal year, which likewise differs among countries).

Transactions must be measured at the same stage: when does an intention become a pledge, a pledge a promise, a promise a binding commitment? Does disbursement occur when resources leave a donor country or arrive in the recipient's hands, or when payment is made by a donor agency against an invoice for goods that may be on the high seas, or not yet out of the factory?

These technical issues are common to virtually all international recording systems, but many others are specific to the analysis of development co-operation. This is where definitions take on their full significance. The borderline must be traced between aid and a straightforward business transaction (aid is aid when resources are provided at concessional terms, with the dominant intention of fostering development; box, p. 12); between official aid and private aid; between economic aid and military aid (which is excluded from DAC statistics on resource flows as not being developmental in nature, but which cannot be excluded from debt statistics); and between private sector transactions receiving official support (officially guaranteed private export credits, for example) and those conducted on

1. Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Sweden, Switzerland, the United Kingdom and the United States.

the initiative of private-sector operators and financed at their own risk (bank loans, portfolio investment and most direct investment).

These are far from the only breakdowns required for meaningful analysis of comparable figures for the review and formulation of development co-operation policies. The share of developmental multilateral organisations and bilateral aid in the total ODA programme of a donor is of interest. The purpose of the aid supplied by each donor to each recipient–and therefore its relation to the purpose and sectoral allocation of the aid supplied to each recipient by all donors combined–is obviously relevant. So is the share of aid that is tied (i.e., must be bought in the donor country), whether to secure the support of home producers for the aid programme, to evaluate the possible additional costs incurred by the recipient country, or again to ascertain the impact on international competition. The list goes on: food aid, technical as distinct from financial co-operation, the terms of lending.... With only ten statistical tables a year per reporting country, the potential contents of the corresponding database are of the order of 8 million items of information, covering all the dimensions of the reporting.

Each dimension requires its own definition and reporting specifications for international comparison and policy review and formulation. For this purpose, the DAC relies on its Working Party on Statistical Problems, which has met on average twice a year since 1969. The Working Party reviews proposals for new statistical reporting (or the abolition of some existing reporting) put forward by member countries or the Secretariat and monitors the reporting rules of the two systems and their respect by reporters. It has attacked such thorny issues as the eligibility for inclusion in aid data of the cost (to donor countries) of administering aid programmes (they are eligible), aid for refugees (eligible in large part), purchases of commodities or raw materials from developing countries at above market price (not eligible), the subsidisation of students from developing countries by direct payments (eligible) or indirectly through free or below-cost access to national educational systems (eligible subject to certain conditions).

The Secretariat draws on its data base to produce a wide range of statistical reports. Some are *ad hoc* extracts, to support review of particular topics that are high on international agendas. Others are routinely circulated to member countries as background for regular meetings, for example, the periodical review of the aid policies and programme of each member country undertaken by the DAC.

What statistics on aid and resource flows are issued regularly to the public? The titles of the three main publications

GLOSSARY

DAC Development Assistance Committee

ODA Official Development Assistance is defined as those flows to developing countries and multilateral institutions provided by Official agencies, including state and local governments, or by their executive agencies, each transaction of which
- is administered with the promotion of the economic development and welfare of developing countries as its main objective; and
- is concessional in character and conveys a grant element of at least 25% (calculated at a rate of discount of 10%)

LDC Developing country

LLDC Least developed country (one of the 42 countries identified by the United Nations as 'least developed')

LIC Low-income country. For statistical purposes, the OECD Secretariat identifies as LICs those countries and territories whose average per capita income in 1987 was $700 or less

LMIC/UMIC Lower and upper middle income country ($700–$1300, and over $1300 UMIC respectively)

DRS Debtor Reporting System (operated by IBRD)

CRS Creditor Reporting System (operated by OECD)

TC(TA) Technical Co-operation (Technical Assistance). The two terms are used interchangeably, and refer to activities intended to improve the knowhow of developing countries and their ability to manage their own resource endowment, as distinct from transfers intended to increase the volume of physical capital at their disposal.

2. These are set out in *A Short Guide to DAC Statistics,* available, like the annual *Financial Resources for Developing Countries* (published in June), free of charge from the OECD Client Services Unit in Paris.

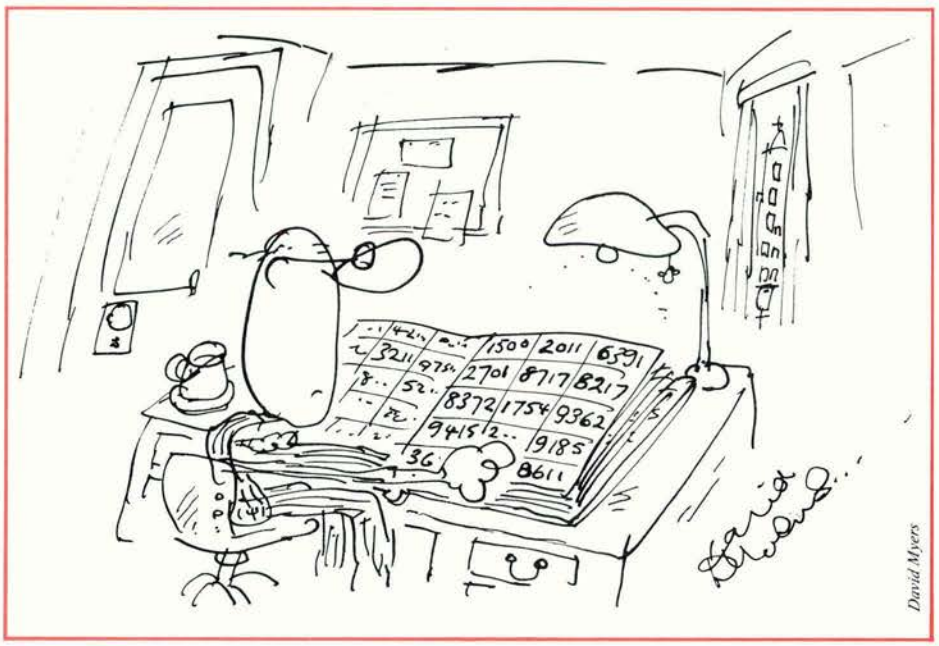
3. For the links between resource flow statistics and debt statistics, and the relationship between the debt statistics proper published by different international agencies, see Bevan Stein, 'World Debt Counts', **The OECD Observer,** No. 157, April/May 1989. The semi-annual *Statistics on External Indebtedness: Bank and Trade-related Non-Bank External Claims on Individual Borrowing Countries and Territories,* published jointly by the OECD and the Bank for International Settlements (most recent issue January 1990) is available free of charge from the Bank for International Settlements, Centralbahnplatz 2, CH-4002 Basle, Switzerland.

are set out in the OECD Bibliography. The data can also be supplied in most instances on diskettes, computer tape or, by special arrangement, direct access to the computerised database. In some subject areas, further unpublished detail may be requested: the geographical distribution of food aid, for example, or alternative combinations of groups of countries and/or categories of aid and/or levels of transactions (EEC countries only, commitments rather than disbursements, terms of aid from all sources or DAC members only to specified groups of recipient countries other than the standard LLDC, LIC, LMIC, UMIC breakdown).

And a word about confidentiality. Most of the data received by the Secretariat are in the public domain, but not all. In some contexts, confidential detail is summed into broader aggregates that can be published. This is particularly true of some of the data on private export credits, bank lending and direct private investment, for which totals by country can be and are published, but not the underlying disaggregate detail on the partner country.

□ □

The DAC statistics are the unique source of comprehensive, detailed data on the sources, volume and terms of the receipts of aid and other resources of each developing country, and of the expenditure on aid of each member country of the DAC (a grand total for all members of $48 billion in 1988). The figures are essentially recorded on a balance-of-payments basis, and so, providing due care is taken to make necessary adjustments,[2] they can be used in association with the balance-of-payments data produced by the OECD and the IMF.



The balance-of-payments conventions are also a bridge towards debt statistics, which are prepared both by the OECD and the World Bank.[3] Squaring the circle, the World Bank's reports from some 120 debtor developing countries on their borrowing from external sources can be used in turn as a source of flow statistics for the loan portion of the record (but not grants or the flow of official or private direct investment). ■

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The Search for International Educational Indicators

Norberto Bottani and Isabelle Delfau

Public concern about education has grown so much in recent years that governments are having to find ways of measuring the performance and efficiency of education systems, and of informing the public of the results. Indicators are among the instruments that can be used.[1]

What do children learn at school? Are some schools better than others? Are some education systems more effective than others? If so, why? How do OECD countries compare with one another in terms of educational efficiency and achievements? What is the return on the substantial investment in education made by countries and parents? Do all countries spend the same on education? And, for a similar outlay, are the results comparable? If not, are there ways of measuring the differences and of discovering verifiable explanations?

These are daunting and, some might even say, heretical questions. Nonetheless, they are questions which have resurfaced in recent years with increasing frequency in educational and political circles, in business and industry and among parents who are understandably concerned to provide their children with the best possible education.

The press in the United States has recently given considerable prominence to the findings of an international survey of the mathematics and science knowledge of 13-year-olds from both public and private schools in six countries (Canada, Spain, the United States, Ireland, South Korea and the United Kingdom).[2] When the findings were published on 1 February 1989, the *Washington Post* came out with a front-page article under the heading 'Survey of Math, Science Skills Puts US Students at Bottom'.

All of the students were given assessment tests that had been originally designed for use in the United States. Nonetheless, Asian, European and Canadian students outperformed their US counterparts: the South Korean students' average score in maths was four times higher than that of the US students; and 40% of the Koreans were shown to have a good grasp of the concepts of geometry, compared with only 9% for the US students. In science, 73% of the South Korean students but only 42% of the US students knew how to use scientific procedures, particularly in processing and analysing data–for example, setting up an experiment and drawing conclusions.

Nations at Risk?

In the light of these findings, borne out by other international surveys, it is easy to understand the concern felt by the country's leaders–concern that had already been voiced in 1983 with the publication of the now widely known study *A Nation at Risk*.[3] This report on the state of education in the United States, which has become the manifesto of the movement for improving its quality, gives vent, in highly emotive phrases, to a marked alarmism: 'Our Nation is at risk. [...] If an unfriendly foreign power had attempted to impose on America the mediocre educational performance that exists today, we might well have viewed it as an act of war. As it stands, we have allowed this to happen to ourselves'.

This pessimism is finding an apparently similar echo in Europe, as witness the debate in France on the elusive 'level of attainment' and its fluctuations–recently challenged by two researchers who contend that 'the level is rising'.[4] Here, too, the renewed questioning of the way education systems operate, in the light of the results they achieve, is giving rise not only to debates but to a multiplicity of procedures for assessing students and the performance of schools. The aim of all this activity is to provide the public with information on which it can base its decisions.

It was against this background and in an attempt to provide at least a partial response to concerns of this nature that the OECD Centre for Educational Research and Innovation (CERI) launched its project on international educational indicators. Its aims are to make education systems more transparent and understand how they function, the better to guide and direct their future development.

Norberto Bottani and Isabelle Delfau work on educational indicators at the OECD Centre for Educational Research and Innovation (CERI).

Daniel Besson

THE NETWORKS

Network 1
Enrolment, Career Paths and School-leavers at Various Stages
Lead country: Australia
Countries participating: 20

Network 2
Education Outcomes
Lead country: United States
Countries participating: 18

Network 3
Functioning of Schools
Lead country: France
Countries participating: 15

Network 4
Assessing Costs and Resources
Lead country: Austria
Countries participating: 15

Network 5
Assessing Attitudes and Expectations
Lead country: Netherlands
Countries participating: 10

Previous attempts at developing educational indicators, at least on an international basis, had demonstrated the weakness of any approach monopolised by specialists in an activity where cultural sensitivities can so easily be offended. So, in order to involve as many countries as possible in the work–an essential prerequisite for its success from a policy-making standpoint–CERI adopted a method of operation based on their co-operation and participation. Five networks were set up, each headed by a lead country (box). Each of the five worked on a set of indicators that had been identified as essentially important.[5] Each country was free to join one or more networks depending on its interests, experience or its priorities in education policy.

Some 200 individuals were involved in the international aspects of these networks alone. At the same time, most countries set up national reference groups to co-ordinate their efforts and promote indicator work on a national scale.

The complexity and diversity of education systems are such that an individual indicator can convey only limited informa-

1. The OECD will publish a report on this subject in 1990.

2. Two 45-minute tests were administered to these students, one on mathematics (63 questions) and one on science (60 questions). The questions were chosen from the 281 questions on mathematics and the 188 questions on science used in the survey carried out in the United States in 1986 by the National Assessment of Educational Progress (NAEP). See A. Lapointe, N. Mead and G. Philips, *A World of Differences. An International Assessment of Mathematics and Science*, ETS/IAEP, Princeton, 1989.

3. *A Nation at Risk: The Imperative for Educational Reform*, National Commission on Excellence in Education, US GPO, Washington DC, 1983.

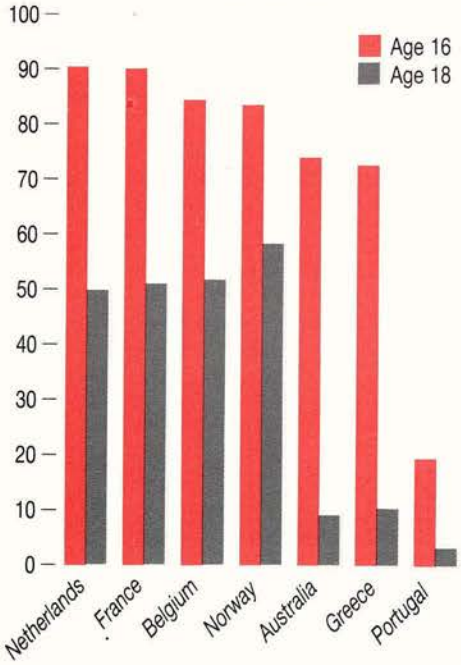
4. Ch. Baudelot and R. Establet, *Le niveau monte. Réfutation d'une vieille idée concernant la prétendue décadence de nos écoles*, Le Seuil, Paris, 1989.

5. The reports of the five networks can be obtained from CERI.

tion. It is therefore essential to build a coherent system of indicators that clearly reflects the state of an education system. Such a system cannot simply comprise a collection of basic statistical data, however easily accessible such data may be. Indicators that are devised without a clear overall concept and without a common frame of reference are likely to produce a jumble of disconnected facts and figures. The indicators must be linked logically if they are to provide an overall picture, and these linkages should proceed from a model or framework, itself equally logical, which describes how the education system works.

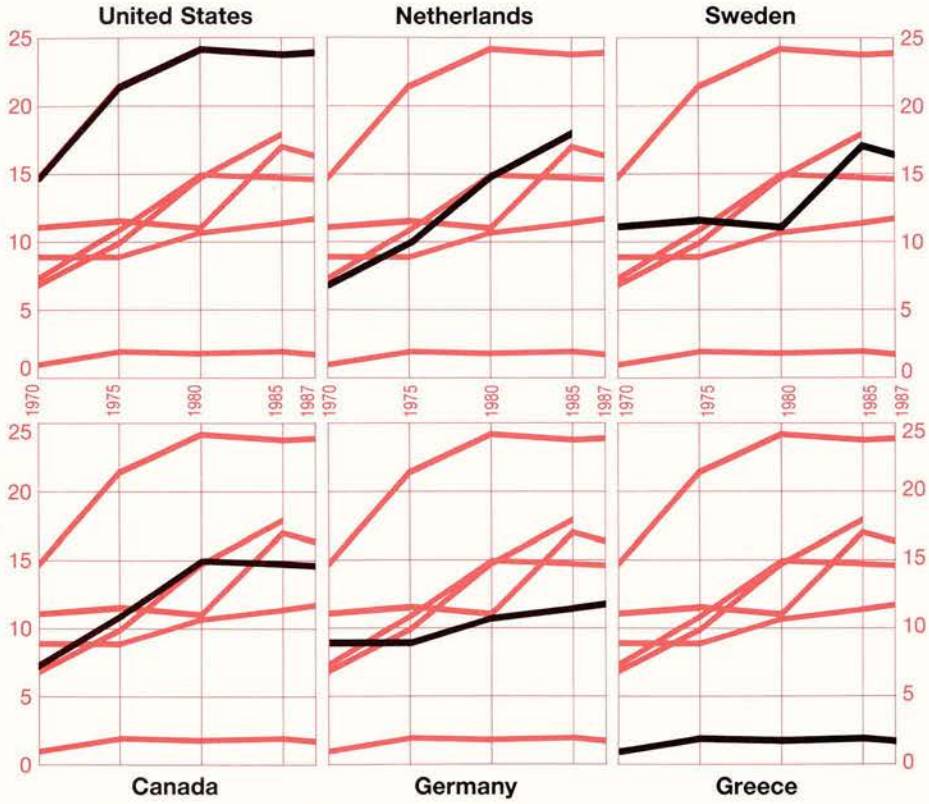
When it comes to developing an international system of educational indicators, choosing a model is particularly difficult because of the differences between countries–in their concepts of policies for education, in the structure of their educational establishments and in their practices and principles of operation. While there may be similarities between both the basics (i.e., the goals) and the way schools and teaching are organised, the disparities, whether superficial or fundamental, mean that much care has to be taken in interpreting indicators.

Figure 1
SECONDARY SCHOOL PARTICIPATION RATES–1988
% of age-group



Source: OECD.

Figure 2
PERCENTAGE OF 25-34-YEAR-OLDS WITH A FIRST DEGREE IN HIGHER EDUCATION[1]



1. International Standard Classification for Education (ISCED) Level 6.
Source: OECD.

Selecting Indicators

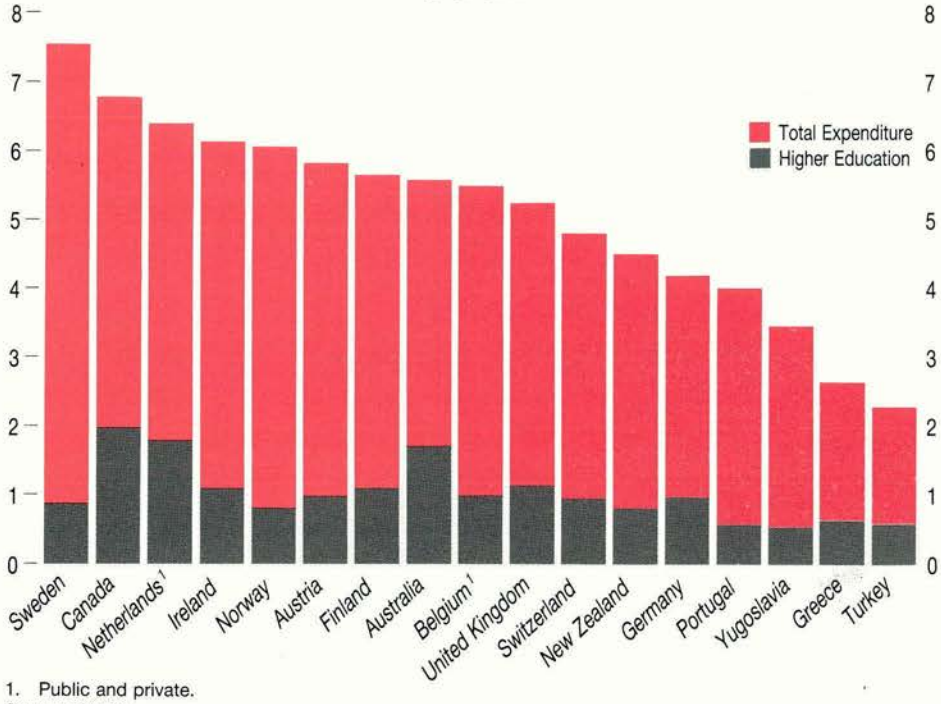
The networks achieved preliminary agreement on a limited number of indicators that are likely to be included subsequently in a set that the OECD would monitor regularly. Some of these can be calculated from existing statistical information, while others require new data that will have to be collected.

Process Indicators
- repetition rate
- attendance rate
- post-secondary entrance rate
- participation rate in full-time education
- participation rate in secondary education
- graduation rate from secondary school

Outcomes Indicators
- percentage of population completing higher education
- post-school activity rate by education level
- science and technical graduates (master's/doctoral degree)
- students' cognitive achievements
- non-cognitive achievements (written expression, for example)

Resource Indicators
- pupil/teacher ratio
- funding of education by source

Figure 3
PUBLIC SPENDING ON PUBLIC EDUCATION–1985-86
% of GNP



1. Public and private.
Source: OECD.

- total educational expenditures as percentage of GNP
- public expenditure on education in relation to social expenditure
- costs per pupil for the different levels of education
- teachers' qualifications.

This process of constructing a system of indicators has highlighted the difficulties involved in finding international indicators that are comparable and accepted by all member countries. In the case of student flows, for example, Network 1 developed a number of indicators to describe participation rates at key stages–the transition from one level to another within the education system and at different stages in higher education (Figures 1 and 2). The next stage will be to determine which of these indicators should be included in the set that will be used as the 'instrument panel' for monitoring regularly the way education systems operate and the improvements that occur.

Network 4 worked on cost indicators which, at first sight, would seem easier to define. But developing cost indicators in a field as complex as education poses considerable difficulties. Before they can be compared on an international basis, a whole series of questions on the aggregation of the basic data in national centres have to be resolved. The OECD has been able to calculate a number of cost indicators (Figure 3) on the basis of the questionnaire devised in conjunction with UNESCO and the Statistical Office of the European Communities.

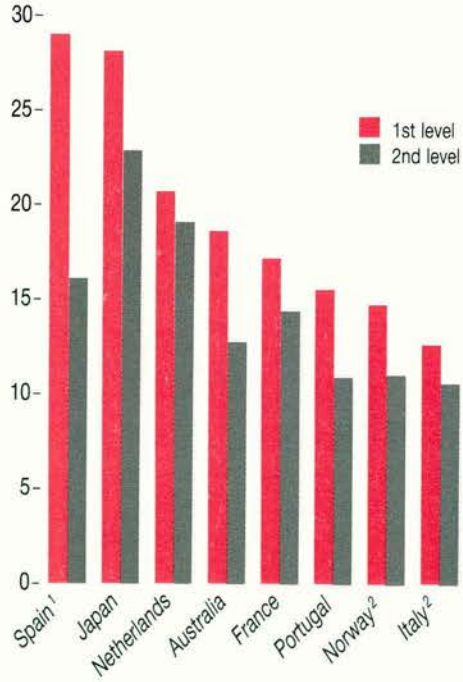
Calculating pupil/teacher ratios (Figure 4) provides a further example of complexity. The changes that have occurred over the past ten or so years have brought new faces into the classroom–for example, full-time teachers specialising in remedial education for low achievers, assistants working with established staff, half- or part-time teachers, and so on.

Working out the number of pupils per class is no easier: classes form and unform, with pupils following what are becoming increasingly personalised programmes of education; classes that remain fixed and immutable throughout the year are becoming less and less common.

Calculating a seemingly straightforward indicator like the pupil/teacher ratio thus becomes a real headache. And the issue is by no means a minor one: if it is true that small classes are 'better'–which is the generally accepted view despite evidence to the contrary from a whole range of specific research on this question–the answer would be to adopt a policy aimed at reducing the average number of children per class, by recruiting more teachers, by building more schools, by keeping on teachers even when the number of pupils is declining, and so on.

One of the main difficulties with this project is selecting, defining and calculating cognitive indicators. It is further complicated by the increased emphasis placed on non-cognitive achievement and

Figure 4
PUPIL/TEACHER RATIO–1987/88
Public and private sectors



1. 1986/87.
2. Public sector only.
Source: OECD.

Michel Benichou/REA

How do you measure non-cognitive achievement?

by the growing tendency to assess outcomes by comparing educational level with entry to employment.

Imagine, for instance, that the selection of indicators were confined to those which measure children's scholastic attainment in what might be termed basic subjects (mathematics, for example). How far would the choice of these subjects be governed by the ease of measurement? And how can one avoid the genuine risk that this might be reflected in the curricula? There is nothing to prevent education in the classroom and in schools as a whole from changing gradually and imperceptibly so as to shift the emphasis onto those aspects that will be tested. Such a shift has already been observed–and sharply criticised–in the United States, where standardised assessment tests have been introduced on a wide scale.

Much care, therefore, has to be taken to avoid a situation where the knowledge transmitted by the school is reduced to that which can be measured. Reasoning ability, the learning strategies adopted by pupils individually and in groups, and the ability to cope with new information, communicate knowledge to others and solve problems–all these also have to be taken into account.

□ □

Constructing systems of indicators is not an end in itself. While they may make it possible to some extent to measure the performance and productivity of education systems, the teaching/learning process is one that embraces goals and costs which cannot easily be expressed in cold statistics. Indeed, that some of the seemingly more accessible aspects of education are not being measured at present demonstrates both the complexity of the task and the importance of a clearer understanding of educational investments.

The desire to 'know', which is a feature of modern societies and of which indicators–educational, economic, scientific and so on–are a reflection, brings with it the risk of introducing a bias. It is important to guard against this danger, particularly in an activity as sensitive as education, which is concerned not only with crude performance figures but also, and above all, with values, beliefs and systems of thought. ■

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Partnerships for Rural Development

Christian Huillet and Pieter van Dijk

What are the changes now taking place in rural areas? And how can they be handled as constructively as possible? The answers, according to an OECD report,[1] can be found in programmes based on partnerships between businesses and central government, municipal authorities, associations, elected representatives–and in a wide variety of sectors: agriculture, industry, employment, environment, town and country planning. This suggests, moreover, that rural policies should be built up at all tiers of government, sometimes even internationally.

Contemporary developments in rural areas call for co-operation by governments, business and other 'economic agents'–and thus for partnerships (box, below). First, the economy itself has changed. With the decline of agriculture, there has been a move towards diversification, and the rural economy now comprises a wider variety of component elements. The expansion and subsequent decline of manufacturing has been accompanied by a proliferation of small businesses, crafts and trades, with an ever-increasing emphasis on services. The economic interests now concerned and the sectoral policies (tourism, town and country planning, etc.) involved in planning rural development are therefore legion.

There have also been striking demographic changes. Most countries have witnessed three very different tendencies within thirty years. The exodus from the

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1. **Partnerships for Rural Development,** OECD Publications, Paris, forthcoming 1990.

INSTITUTIONS, AIMS, HISTORY

Partnership in rural development is understood to encompass any system of institutional co-operation, ranging from legally binding contracts to informal arrangements. To be a success, it must have a suitable institutional framework and clearly defined aims. Responsibilities must be established, powers and risks equitably shared, and there must be efficient communication among the various partners, who on occasion may number ten or more. All kinds of partnership are possible: between the public and the private sectors, or within the public sector ('horizontal' partnerships between ministries or communes, 'vertical' partnerships between different tiers of government up to and including the CEC).

Institutionalised public/private sector partnership is a long-established practice in countries like Switzerland, Austria, Germany and some English-speaking ones. In the United Kingdom, for instance, the history of the Rural Development Commission goes back to 1909, when rural commissioners were appointed for various parts of the country (Wales, Scotland and England) to implement locally schemes initiated by central government. Nowadays, the Commission works hand-in-hand with many public-sector agencies as well as with local organisations and businesses.

Elsewhere, for both institutional and cultural reasons, the idea of partnership has been slower to take hold. Even in countries which have adopted a decentralised pattern of territorial organisation, as France now has, putting partnership schemes into systematic practice is fraught with difficulties. One of these, and by no means the least, stems from limitations on budgetary powers; another is derived from the geographical spread and economic importance of rural communes, which may complicate the management of certain operations.

Partnerships have proved to be particularly useful in implementing rural policy because they smooth the way for co-operation between sometimes hidebound government departments in different ministries and for the complementary functioning of different tiers of government (central, regional, sub-regional and local), as well as in bringing together a wide variety of economic and social interests in the private sector (banks and chambers of commerce, for example).

PARTNERSHIPS WITH CANADA'S ABORIGINAL PEOPLES

Jean Valentin/Explorer

Two years ago the governments of Canada and the Province of Quebec signed a 'Memorandum of Understanding' (MOU) to facilitate co-operation on economic development in the areas where Canada's aboriginal peoples (Indians, Inuit and Métis) are concentrated. One-tenth of the current aboriginal population of 700,000 lives in isolated and remote parts of Quebec, some inside the Arctic circle, where many handicaps impede development. According to the 1981 census, 41% of these peoples receive only nine years' schooling, and the difficulties this causes are compounded by others that confront them when they try to gain access to capital and to financial networks, by their isolation from major markets, by inadequate physical infrastructures and by restrictions on the use of reserve assets as collateral for business loans.

The MOU aims to harmonise the policies and programmes of the Federal and Provincial governments, to examine obstacles to participation by the aboriginal peoples in Quebec economic life and give them a voice in any initiatives planned. Seventy directors from 29 ministries and agencies (13 Federal, 16 Provincial) meet regularly in working groups under the auspices of the Canada-Quebec Co-ordinating Committee, which is responsible for implementing the MOU.

An Advisory Committee comprising members of the aboriginal peoples reports to the Co-ordinating Committee. It includes representatives of the Quebec Inuit, the Secretariat of the First Nations of Quebec, the James Bay Aboriginal Development Society (Cree), the Quebec Native Alliance (Métis and Non-Status Indians) and the Attikamek-Montagnais Council. It is consulted on questions arising from MOU implementation plans, working-group findings and co-ordination strategies.

AUSTRIA: PARTNERSHIP IN THE WALDVIERTEL

Buchmayr

Uneven regional economic development between the east and west of the country has led Austria to introduce a change of direction into its traditional rural development policy. Priority is now given to 'endogenous renewal' and 'self-reliant development'. This new initiative relies on partnerships between the federal and regional authorities via 'state treaties' and involves both the public and private sectors.

The Waldviertel, an agricultural area in north-eastern Austria, is a particularly interesting instance of policy which promotes rural development through partnerships. Following a study carried out by the Austrian Regional Planning Institute, in consultation with the relevant federal ministries, the Office of the Lower Austrian Government, representatives of industry and the Waldviertel Regional Development Committee, a five-point plan has been implemented. The objectives are to promote the settlement of businesses and assist firms which already exist; to step up counselling services; to establish spas and recreational centres so as to promote tourism; to find new openings for farmers; and to upgrade the regional communications network, especially the railways.

The Federal and Lower Austrian governments have worked together on a variety of assistance measures encompassing, in particular, aid to job creation and an incentive scheme to promote self-reliant development. The plan is ratified in a 'state treaty' between these two levels of government, each party having nominated a rural development consultant.

countryside in the 1960s was succeeded in the '70s by an influx of city-dwellers attracted by a better quality of life. In the '80s, this flow seems to be slowing–even drying up altogether. The socio-cultural mix in many country areas is thus much more varied, and differences in life-styles and values have occasionally led to conflicts.

There has been a third change. Rural areas have been given a new function, that of a 'repository' of ecological assets, now that the management of the environment is increasingly important. This has led governments to pay increasing attention to these areas.

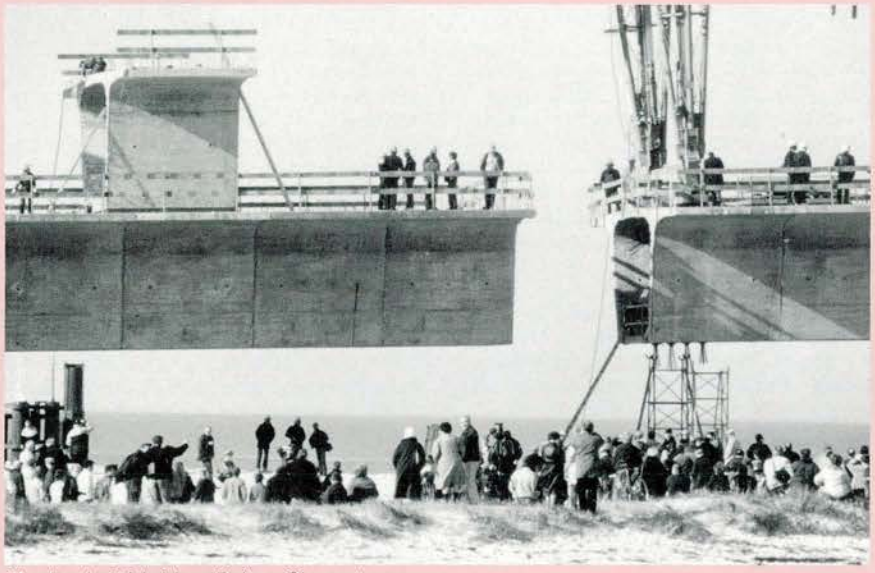
Lastly, the institutional reforms introduced in some countries in recent years to further decentralisation have given a boost to regional and local initiatives and to 'self-reliant' development. In Germany's *Länder* this is nothing new, but in France, for instance, where the exercise of power by the regions is more recent, it is something of a novelty. The political and administrative structures involved will modify the formulation and implementation of rural policy. For example, the *Länder* and the French regions increasingly want to be directly responsible for defending their own interests in the Commission of the European Communities (CEC).

Self-reliant development has brought new local decision-makers to the fore, not least voluntary and non-profit organisations. It has also impelled governments, which formerly regarded rural areas purely sectorally–because of agriculture, above all–to rethink their strategies and methods. Since the concept of integrated development is here to stay, any future analysis must cover all sectors. Partnerships have therefore become a necessity. But what form should they take? And how can the most be made of them?

Different Kinds of Partnership

Drawing up a typology of partnerships is no easy matter–and in any case would probably be pointless, since partnerships should routinely be able to deal with a variety of problems. While one government may set up a co-ordinating committee re-

FRANCE: FROM AGRICULTURE TO RURAL DEVELOPMENT



T. Orban/Sygma

The Ile de Ré bridge, Poitou-Charentes.

France's 'problem areas' are of two main types: areas in structural decline which are gradually being deserted as a result of the aging of the population and immigration; and those where farming is still the main activity and where redeployment will be necessary as reforms under the CEC's Common Agricultural Policy come into force. In the 1970s development aid policies tended to be sectoral and aimed at the modernisation of agriculture. But as demographic and economic balances in rural areas changed, it became clear that a multi-sectoral approach, covering more than the farming areas alone, was required. Development nowadays involves the settlement of a young working population, reorganising public services and making them more accessible, promoting tourism and adapting agricultural production systems. Villages and small towns must be involved too, since they can more easily attract development.

The decentralising legislation enacted in 1982 and 1983 created the right climate for partnerships. Many 'actors' are now involved in rural development in France. The *commune* is responsible for managing its own territory and neighbourhood facilities, the *département* for physical infrastructures (notably roads) and the *région* for economic planning and development aid; central government oversees implementation of agricultural policy, town and country planning and environmental concerns. And last but not least, since the doubling of CEC Structural Funds in February 1988 the European Community has been playing an even more important part in defining agricultural policy and setting up rural development schemes.

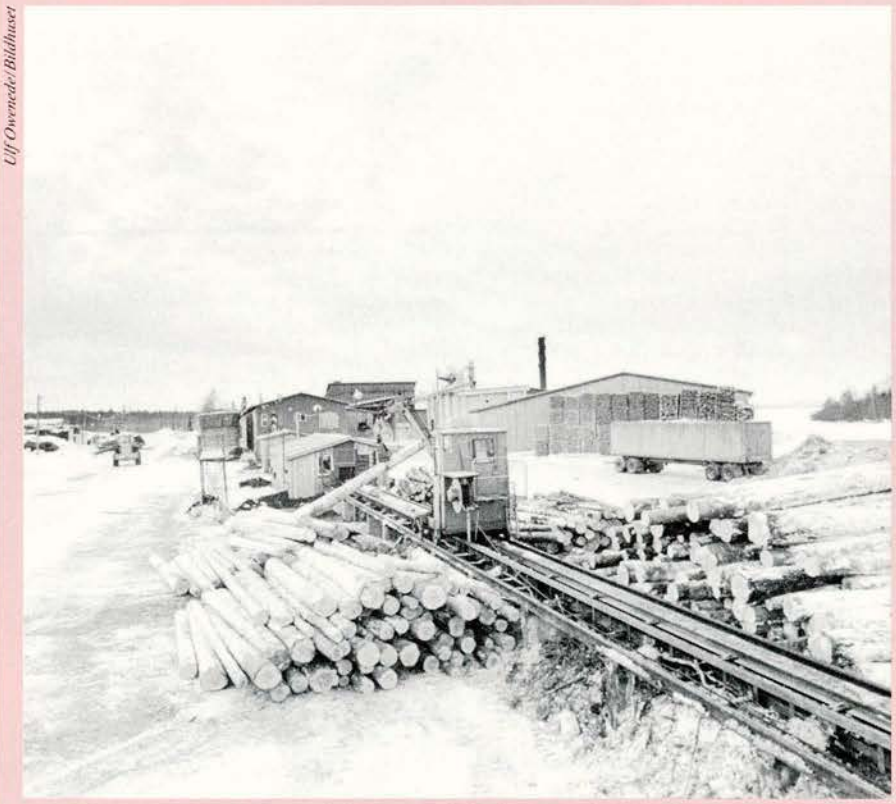
In 1988 the Ministry of Agriculture and Forestry launched pilot schemes for development in three 'problem areas': the Poitou-Charentes region, Central Burgundy, and Lozère in the Languedoc-Roussillon. These experimental schemes, which extend over several years, are run jointly in a three-tier system: a national interministerial steering committee is supported by regional co-ordinating bodies, and at the grassroots matters are taken in hand by a partnership comprising elected representatives of local government, local civil servants and the private-sector consultancy bureau. It is the bureau which has responsibility for identifying the competitive strong points and putting forward proposals for development. In the Poitou-Charentes, of the eight sectors picked out in a strategic analysis of the local economy, only five were finally chosen. The decision was made on the basis of a method first developed in the private sector in the 1960s, whereby internal and external assessment (of market opportunities and of comparative advantage) allows the enterprise to choose niches where it could be competitive. The Ministry adopted this procedure for areas it wishes to help out of difficulty.

SWEDEN'S RURAL POLICY ADVISORY COMMITTEE

For decades steady population losses, declining employment and inadequate amenities in the inland areas of northern Sweden have obstructed development. Some ten years ago the Swedish government set up a Rural Policy Advisory Committee to work for improvements in the living conditions of the people living there. The Committee comprises officials from the Ministries of Industry, Labour and Agriculture and from the 24 State County administrations concerned, representatives of the political parties which hold seats in parliament and of organisations whose members are drawn from the municipalities concerned, county councils and farmers. Its mandate encompasses all kinds of matters, from job creation through social issues to the installation of shopping facilities in remote villages.

The Committee initially concentrated on drawing up an inventory of the problems and development potential of the communities concerned. Once this had been done, it set out to assist the decisions of local bodies on rural development policies. For a long time its budget amounted to no more than SKr 1 million (around $163,000) and although in the last two years this sum has been increased to SKr 5 million, even with these augmented resources activities still have to be jointly funded. Indeed, the Committee's direct financial contribution is often very slight compared with those of the municipal or county administrations. Many projects have nevertheless been completed or are currently under way, among them 'village of the future' projects where the aim is joint action to modernise villages and so attract new residents. To this end, too, the Committee has contributed by collaborating in the installation of up-to-date telecommunications facilities.

Through its participation in a host of such projects, the Committee has built up a countrywide network of contacts, not only with municipalities and government departments but with political parties, too. It is thus able to influence discussions, decisions and policy initiatives involving rural areas.



Ulf Owenede/Bildhuset

sponsible for rural policy, as Sweden has done, another may prefer to devise a procedure for development planning which associates many partners over several years and which meets the particular difficulties of an area, rather than establish any national development agency.

Each problem engenders its own partnership recipe. Greece, for instance, is experimenting with regionally-based planning contracts. The first pilot scheme began in 1985 in the Gulf of Amvrakikos, a typical underdeveloped rural area, with the negotiation of a contract associating the central government, the local authorities and the private sector. The objective is to foster local initiatives, even if this were to require a partial transfer of administrative powers.

Portugal launched an integrated development operation in the northern part of Alentejo in 1986, centred on upgrading infrastructures, changing the pattern of agriculture, promoting tourism, stimulating rural industry and creating jobs. The private sector, trade unions, the CEC, local communities and the central government are all involved.

□ □

Although recipes vary, the same conditions must always be met if they are to be successful. A partnership cannot be imposed. It comes into being as a result of consensus and the determination of the groups involved to work together–it is self-feeding, and the richer for it. But like all human endeavours, it has its frailties, the more so when results take time to materialise, as often in rural development. The schemes that are running smoothly today have usually been the result of operations over several years. ■

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Trimming Investment Disincentives

Anthony Kleitz

Maillac/REA

Among the activities affected by TRIMS: drilling for oil...

What are trade-related investment measures (TRIMs)? They are, in short, conditions which governments impose upon investors and which artificially change trade flows. Although precisely which measures should be considered TRIMs remains controversial, the most commonly mentioned appear in the box on p. 25.

TRIMs present a wide variety of characteristics:

- investors generally view them as investment disincentives, as they impose additional costs on future operations and profitability; however, they are often balanced by measures which ease other burdens (such as taxes or import restrictions)
- they often lack transparency–while they may be applied on the basis of explicit laws or regulations, they may also result from implicit requirements; moreover, the exact conditions are often negotiable, though the final terms may not be publicly disclosed
- they may be imposed at the time of initial investment or sometimes only after it, in which case the investor may find his freedom of action considerably compromised, since he is already financially committed.

In using TRIMs, governments generally aim to achieve a desired pattern of eco-

Government controls on international investment activities can distort trade significantly. What form do these measures take? How serious are the distortions they create? And do they call for strengthened multilateral disciplines, despite the traditional autonomy of countries to fix their investment policies?

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nomic development. They seek to influence what goods are produced and in what quantities, the origin of inputs, the production technology, the volume of employment, the use and acquisition of skills, where the products are marketed, and so on. They sometimes see TRIMs as helping to counter other distortions in competition (some of the practices of multinational enterprises, for example). Furthermore, some governments hope that the use of TRIMs will strengthen their balance of payments and foreign exchange reserves. These objectives appeal particularly to developing countries. The question is how much TRIMs help achieve them.

Mailliac/REA

Electronics...

Trade and Economic Distortions

Most direct investment affects trade, either by increasing the supply of finished products and the demand for inputs in a particular area or country, or by changing production possibilities. But when TRIMs are applied the investor is forced to accept certain government-sanctioned obligations that modify trade flows from what they would be when companies make commercial decisions that reflect the interplay of market forces. TRIMs are, of course, not the only source of trade distortions, but they increase the overall degree of distortion and thus reduce trade and economic efficiency.

These net effects–for the 'host country' where investment takes place, for the 'home country' from which the investment originates, for 'third-country' trading partners and, ultimately, for the entire world–are made up of a series of micro-effects, losses to some parties and gains to others.

The short-run distortions that TRIMs create fall into two patterns.

First, when a TRIM (such as a local-content requirement) restricts the use of foreign inputs, it forces a reduction of imports, which must then be replaced by higher-cost and lower-quality domestically produced inputs. This provides a 'rent', an unearned bonus that free competition would have eliminated, to the domestic suppliers of those inputs, but it forces the investor either to cut his potential profit margin or to raise his prices. The quantity of finished goods produced by the investor will probably be less than if inputs could be chosen on a commercial basis.

As a counterpart, home-country and third-country exports of inputs will be reduced, depressing production and profits in those countries.

Second, a TRIM (such as an export-performance requirement) may mandate high volumes of exports of finished products

G. Boutin/AAA

Food manufacturing...

by the host country. Since this is possible only if the price is competitive on the world market, the exports may have to be sold at a lower price than that charged in the host country. To achieve this end, the firm might have to cross-subsidise these exports from other, more profitable activities. In addition, if investors are obliged to produce inputs locally in order to meet TRIM requirements, they may seek to achieve economies of scale and thus lower costs by exporting those inputs as well as the finished goods; in such cases, to gain market share abroad, they may also initially sell the inputs there at artificially low prices.

As a result, home-country and third-country imports may expand as producers in those countries are displaced by producers in the country where the investment was made. Consumers would evidently benefit from lower prices in the short term, although competing producers in home and third countries would be hurt.

These distortions often persist over the longer term, too. The introduction of non-economic factors into production, pricing and marketing decisions leads to a distortion of resource allocation both in the host country and abroad, and the benefits of international specialisation based on comparative advantage will be lost, at least partially. In particular instances a firm affected by a TRIM might be able to take advantage of local conditions (such as a protected market, or other government incentives) to develop into an efficient and competitive producer. But it is much more likely that adverse effects on competition and growth will snowball, increasingly hampering the economic and financial evolution of countries imposing such measures.

The Benefits of Free Trade Flows

The arguments in favour of disciplining TRIMs to reduce these distortions are essentially those which support freedom of investment and trade flows. While the different elements of these arguments are closely inter-related, six main strands may be distinguished.

Trade Expansion

The elimination of distortions would allow the development of trade on a basis which reflected the most efficient allocation of resources. An important aspect of foreign direct investment (FDI), particularly in the short term, is the trade it creates between affiliated parties. Investment is often undertaken to supply a parent corporation with certain products or to help produce and market a good in which the firm has a comparative advantage and for which it wishes to expand its market. And over time, as the local market develops and local producers gain experience, both production and marketing decisions may come to be taken on a more autonomous basis. Trade patterns may thus change, possibly involving a larger number of different products and different suppliers or markets. Affiliated trade may then level off or even diminish in importance as an element in the total expansion of trade.

Transfer and Development of Technology

FDI typically involves the sale or transfer of intangible assets such as technology, expertise, managerial skills, and so on. These may be necessary to make the new production successful. As demand strengthens and production seeks to respond more efficiently, there may be an impetus to transfer additional technology or to develop indigenous models. TRIMs which mandate transfer of technology and of the results of R&D generally backfire by making investors reluctant to transfer

SOME TYPES OF TRIMS

- *Local-content requirements* specify that a certain proportion of inputs used in a production process must be produced or procured in the host country
- *export-performance requirements* insist that a specified proportion of production must be exported
- *trade balancing* limits an investor's imports to some proportion of his exports
- *international product mandating* involves a commitment by the investor to supply specified foreign markets exclusively from his production site in the host country
- *manufacturing or sales requirements* specify that the investor must or must not produce certain products locally and, in the first case, where these products must be sold
- *requirements for local licensing, technology transfer or local expenditure on R&D* oblige investors to use specified technologies, or to develop new ones, in their production
- *local-equity requirements* specify that a certain percentage of a firm's equity must be held by local investors; this may enable them to have a determining voice in sourcing, production, staffing and marketing decisions
- *remittance or exchange restrictions* limit the right of foreign investors to repatriate returns, limit their access to foreign exchange and therefore their ability to import, or link the availability of foreign exchange to a company's export earnings.

more than is absolutely necessary or to up-grade the technology content of local production. Such TRIMs, moreover, may act as a serious disincentive to investment when the protection of intellectual property rights in the host country is perceived as inadequate.

Creation of Employment

For host countries, inward direct investment is inherently job-creating, particularly when differentials in labour costs are a prime motivation for that investment. Over time, the volume of employment and degree of skill would normally increase, as domestic and foreign markets develop and production is adjusted to meet demand more precisely. But TRIMs generally reduce the longer-term employment potential by restraining production through higher costs or by limiting marketing possibilities.

Economic Efficiency and Productivity

If the costs imposed by TRIMs were reduced or removed, investors would be able to benefit more from globalisation of production and to rationalise their use of resources, not only of inputs (labour, materials, capital goods or management skills) but also for the development of new technology and products. The ability of investors to make production and marketing decisions on the basis of commercial considerations will stimulate domestic and international competition.

Improved Prospects for Economic Development

Access to external capital can be important for economic growth and development and avoids some disadvantages of other sources of external financing, such as commercial bank debt. Overall, balance-of-payments problems would be eased and the expansion of the industrial sector facilitated.

Multilateralisation of Trade-related Investment Regulation

Small firms are particularly disadvantaged by TRIM requirements as they may be unable to meet the additional costs imposed. Similarly, small countries do not have the same ability as larger countries to impose TRIMs, since the disincentive effect of these measures on investors is not compensated by a large market. These problems are aggravated by the fact that in the past, investment relations between countries have largely been determined on a unilateral basis or else in the context of bilateral investment treaties. This inevitably increases the influence of parties with more economic or political strength.

M. Renaudeau/Hoa-Qui

The processing of agricultural products...

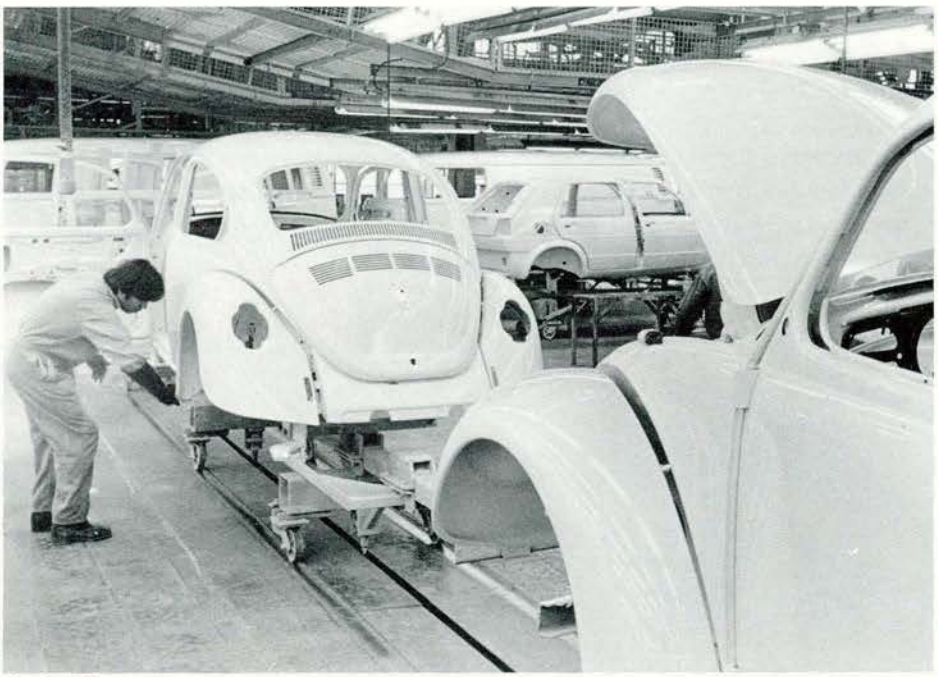
TRIMS IN ACTION: THE AUTOMOBILE INDUSTRY

One of the sectors in which TRIMs have been the most widely used is the automobile industry. Automobile manufacturing is relatively footloose, in that the necessary raw materials, labour and infrastructure are readily found in many countries. To obtain the advantages of automobile investment (employment, upgrading of skills, production of parts, increased export potential, and so on) host countries have often offered incentive packages to potential investors.

Although many countries have resorted to TRIMs in this sector, a fairly striking example can be seen in Brazil. Export performance and local content requirements have been applied there to foreign and domestic automobile investors as preconditions for obtaining incentives. Incentives available include a 50–90% reduction of import duties and taxes on imports of raw materials, components and new or used machinery and equipment. In return, the manufacturer is committed to export a specified value, to maintain a trade surplus and not to import products for which there are 'adequate substitutes' available from local sources. Firms that are at least 51% domestically owned and achieve certain targets of export growth are eligible for preferential loans. Incentives in the form of tax relief are also offered to companies in return for increasing local content in production, usually to a target of 80–90%.

In light of the rapid growth of international investment in recent years, it seems important that regulation of the trade aspect of this investment should be 'multilateralised'. This would clarify the rights and obligations of different countries and in particular defend the interests of 'innocent' third countries whose trade and economic development would be impaired by distortions introduced through the TRIMs of others. It could also lay the way for a broad, reciprocal undertaking of liberalisation obligations.

In general terms, the preamble to the General Agreement of Trade and Tariffs (GATT) recognises the multilateral objectives of raising standards of living, ensuring full employment and a growing real income and expanding production and trade. Agreements to reduce or eliminate



Liba Taylor, Londres

Car-building....

discriminatory and other adverse effects associated with trade policy measures are an important means of achieving these objectives. Although the GATT has concerned itself very little with TRIMs in the past, the decision in 1986 to include the subject in the Uruguay Round represents international recognition of the desirability of multilateral disciplines on them.

Shaping a Sound Investment Policy

By using TRIMs, host-country governments reveal a misgiving that the foreign direct investment they seek to attract might provide only limited benefits to their economies. This fear seems to arise partly because of other distortions affecting the competitive environment in which investors operate, such as rigidities in the host-country market or anti-competitive private-sector practices. It is natural for governments to be interested in shaping effective investment policies. But they will generally be most successful by avoiding TRIMs and the resultant trade distortions.

This argument suggests that governments should concentrate on creating a general climate of business confidence by enhancing possibilities for expanded production or trade, rather than emphasising particular incentives and disincentives for achieving micro-economic goals.

For example, the decision of foreigners to invest and the way in which they operate subsequently will be encouraged by measures which build up infrastructure, which attract or help to develop technology, which support training programmes, which strengthen the legal system in areas important for business (such as company law and the protection of intellectual property rights), or which serve to establish consistent, predictable and non-discriminatory investment legislation and enforcement. Moreover, regulatory practices which are clear, stable and non-discriminatory avoid the unproductive use of resources in activities such as 'rent-seeking' (the pursuit of economic advantage under conditions of imperfect competition). Competition policy provides governments with another instrument for strengthening the benefits of inward direct investment, by limiting the possibilities for abuse of market power and other anti-competitive behaviour by enterprises.

These various policy approaches contribute to a healthy atmosphere for investment without creating government-mandated distortions of prices and trade patterns. Host-country governments can further reinforce this climate by making their investment policy transparent and by providing actual and potential investors with an opportunity for dialogue, so that an atmosphere of co-operation can enhance mutual benefits.

□ □

Although current practice allows individual countries a large amount of autonomy in establishing their investment policies, it is now recognised that the international community has an active role to play in maintaining the multilateral trading system, which provides a general framework for the reduction of trade barriers and guarantees the benefits of such liberalisation for other countries. Specific attention to those trade distortions caused by TRIMs would no doubt be broadly beneficial to all countries, strengthening the contribution that trade and investment can make to economic growth. ■

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The Trade Effects of Environmental Regulation

Ebba Dohlman

Public and political attitudes to the environment have changed dramatically, often giving priority to the environment over economic growth. The 'greens' have emerged as a powerful political force. And consumers are increasingly aware of the impact of their choices on the world they live in. These changes present governments with a significant new source of pressure to alter their policies in ways which might have implications for trade and trade policy.

Measures to conserve the environment can often involve trade policy or have direct or indirect implications for trade. In the past, these spillover effects were rarely questioned since it was assumed that they were both necessary and beneficial. And in more recent years there has been a marked proliferation of national environmental regulations as well as of international agreements on environmental control.

Two main kinds of trade effects may arise from environmental regulations. The first is when trade policy measures–import or export restrictions, for example–are used directly as tools to help achieve the objectives of environmental policy. The second emerges less directly, through the setting of national or regional standards which, when different from those applied elsewhere and entailing a compliance cost, influence the international competitiveness and trade of firms subject to these standards.

The most direct relation between trade and environmental policies appears when trade-policy instruments serve as a principal or complementary means for achieving environmental goals by restricting or prohibiting international trade in certain products.

Examples are numerous. Endangered species, or products from them, may be subject to export controls as provided for under the Convention on International Trade in Endangered Species of Wild Fauna and Flora (CITES), administered by the United Nations Environmental Programme (UNEP). Some countries have imposed unilateral import bans on furs, skins, leather, products of the whaling industry and, more recently, on ivory. The 'Basel Convention on the Control of Transboundary Movements of Hazardous Wastes and their Disposal', adopted in March 1989, and the 'Montreal Protocol on Substances that Deplete the Ozone Layer' (1988) both include export and import restrictions affecting countries that are not party to the conventions.

In some cases, it might not be possible to achieve environmental goals without these restrictions. There would be no point, for example, in compelling domestic industry to manufacture environmentally sound products or substitutes if consumers could import the products now discouraged from countries which do not implement the same strict regulations.

But the benevolence of such trade restrictions might be contested by other countries, thus giving rise to trade frictions. Certain exports restricted for environmental reasons may be essential inputs for foreign producers. For example, cutbacks in the production of chlorofluorocarbons (CFCs) for export might cause disruption in developing countries which are still modernising their industries and which do not possess the technology to produce alternatives. And banning or regulating the trade in ivory, although a measure of literally vital importance to the African Elephant, will hurt the ivory-cutters of Japan and Hong Kong, just as wood-processing industries will be damaged by export bans of tropical timber.

Import restrictions may also be regarded, rightly or wrongly, as a disguised form of protection for domestic industries, or as discriminatory. The Danish government, for example, was taken to the European Court because it decided that all beers, soft drinks and mineral waters should be sold in refillable containers, allegedly a restriction of free trade (the Court ruled in Denmark's favour). And some car-producing countries might perceive the stricter exhaust emission regulations of others as a disguised form of protection.

The temptation might also arise to use trade policy measures more aggressively, to penalise countries which do not accept certain product or production standards–although so far such cases are purely hypothetical. One country might, for instance, impose a border surtax on imports from a neighbouring country which is a major source of atmospheric pollution. The central policy question this instance raises is, of course, how effective are trade-policy measures for achieving environmental goals? The answer obviously depends on the individual sets of circumstances and, with few precedents, is likely to be speculative.

'Global warming' has ensured that deforestation occupies the headlines with a regularity that would have astonished conservationists a decade ago. Several producers of tropical timber have already prohibited exports. In the mid-1980s the Philippines and Indonesia prohibited the export of raw logs, and in January 1989 Thailand banned logging altogether because of overcutting. Brazil has also proposed an export ban.

But export bans tend to be less easily enforceable by customs authorities than are those on imports. Indeed, it is reported that smuggling still accounts for a large amount of trade in tropical timber, especially from Borneo to Sarawak, and in the Philippines where more than a third of timber exports are reported to be contraband.[1]

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Georg Gerster/Rapho

How effective would be an import ban on tropical timber?

Steve Jackson/Rapho

From Logging to Logrolling

And there are other reasons that export bans on raw materials alone might not protect the rainforests. The motivation behind these trade restrictions may be rather to develop local processing industries, thus perpetuating the massive logging. That may already have happened in South-East Asia. Indonesia has created a successful plywood industry. Thailand is importing hardwood from Laos and Burma for its processing. The Philippines

1. *The Economist*, 22 April 1989.

and China have also become net importers. An export ban in Brazil, on the other hand, is unlikely to have much impact on conservation since the problem there is not so much one of commercial logging as of land clearance by potential settlers.

So what would be the efficacy of import bans on tropical timber? Some might argue that a widespread ban would decrease the value of the stocks so much as to make trading unprofitable, even when illegal. They would also argue that the absence of legal trade makes it easier to suppress illegal trade.

Others contend that the effect of a ban would be to drive up the prices even faster and thus increase the incentives for smuggling. In any event, if one single importer refuses to take part in the ban, the chances of its success are substantially reduced. Indeed, to be successful, it would also have to be extended to processed goods; but since commercial logging is big business in South-East Asia, the effects of such a ban on these economies would be devastating.

With Brazil, on the other hand, an import ban by trading partners would solve very little. What would help put an end to the devastation of the Amazonian rainforest would be the stopping by the Brazilian government of its direct and indirect subsidies on land investment and agricultural development.

A Market for Natural Resources

Indeed, are trade bans the only way to help the tropical forests to survive? Is not part of the problem the mismanagement of resources? Finding ways to improve forest management and commercialisation of tropical forest products, such as fruit and rubber, or encouraging pharmaceutical companies to invest locally in the research or cultivation of plants used for healing may provide solutions. Such a far-sighted approach sees the encouragement of trade–not its suppression–as a much more effective guarantor of environmental stability.

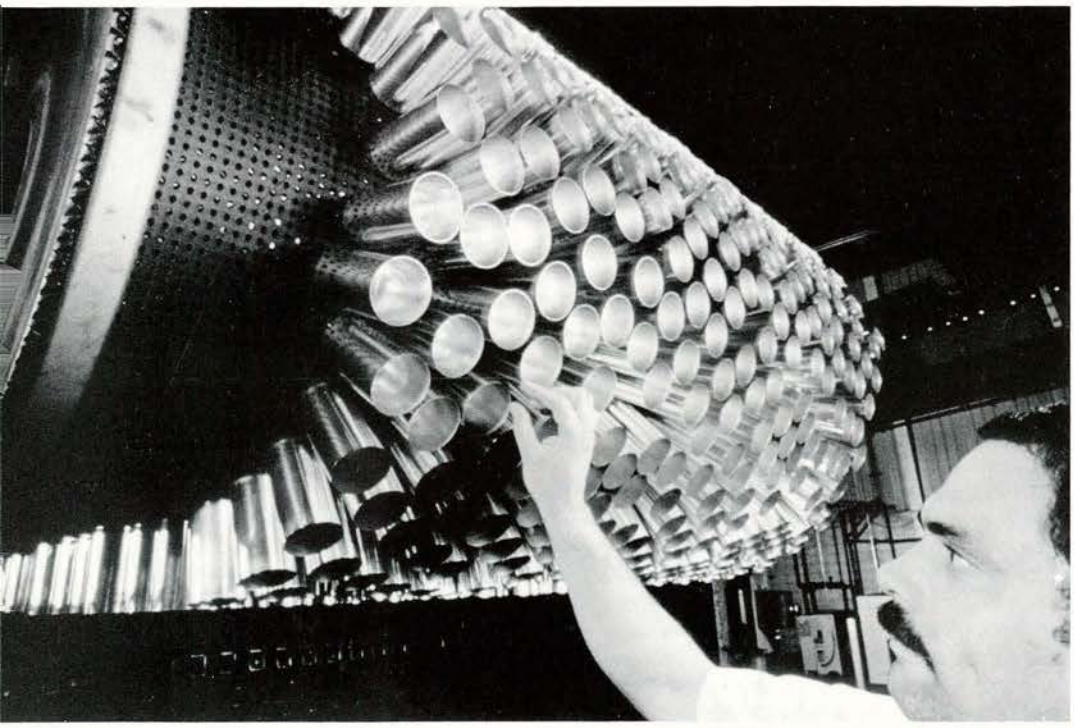
Plans to prohibit the import of ivory have also received widespread support in recent months. In June 1989 the United States announced a ban on imports of ivory. In the same month a ban throughout the European Community, to cover raw and worked ivory, was also called for. Australia, Switzerland and Japan have adopted total or partial bans. And Canada announced its intention to take measures to impose further restrictions on imports of raw or worked ivory from African elephants.

More recently yet, CITES, the world body controlling wildlife trade, at its meeting of 17 October 1989, approved a compromise proposal that placed the African Elephant on the endangered list (thus effectively banning trade in elephant tusks) but also created a special panel of experts to consider future exemptions. Opponents of the ban argue that it would punish the countries that were managing their wildlife successfully and that proceeds from ivory sales helped to maintain this successful management.

What Effects on Competition?

Standards, whether imposed on product or production, may introduce distortions in the conditions of international competition. With automobiles and other motor vehicles, standards may be set on emissions of carbon monoxide, particulates, sulphur dioxide and nitrogen oxide, all of which have respiratory consequences as well as contributing to acid rain. But at any moment more stringent standards exist in some countries than others, forcing car producers to vary the specifications of their cars depending upon the market.

The adoption of strict standards in one country clearly puts pressure on others to modify the nature or composition of their exports or even to adopt the standards themselves. The United States, Japan, Switzerland and the Scandinavian countries have maintained strict but not identical controls on automobile emissions for some time. The European Community is introducing stricter standards over time, as is the United States. This domino effect increases the costs for producers and consumers alike. It is, for instance, expected that the introduction of catalytic converters to new cars produced in



Kevin Horan/REA

The European Court of Justice ruled in favour of Denmark's ban on disposable drink containers.

Hartingue-Violler

The historical trade in whale products has been much reduced in recent decades.

Europe will increase the cost to the consumer by 7–12%.

The Netherlands recently proposed a tax rebate on any car fitted with catalytic converters bought in anticipation of the introduction of mandatory EC standards. The measure would have obvious implications on sales of cars without converters. The proposal arose in the context of a long-standing dispute within the Community over standards, especially as Germany, Denmark and Greece followed suit with similar proposals. The EC Council finally voted for the implementation of car pollution controls for small cars, to be applied throughout the Community by 1993.

The expense of developing substitutes or modifying production methods may be felt to undermine the competitive advantage of certain producers over other producers better able to absorb the costs. Moreover, the high costs incurred, combined with different national timetables for the implementation of particular environmental standards, may make the pace at which substitutes are developed very uneven, thus introducing further possibilities for the distortion of competition and trade.

Yet the market for the initially more expensive products is hard to predict. There does appear to be an increasing demand for 'green' products, at least in the most environmentally conscious OECD countries. In many developing countries, nonetheless, it might be necessary to consider ways of providing incentives for them to introduce substitutes for pollution-intensive goods and production methods, even at the risk of some distortion of trade.

Spiralling Intervention

The response of governments to the new costs will vary and therefore potentially introduce new distortions. One important question which then arises for trade policy is how to allocate the cost of compliance. When the costs are internalised (that is, borne by the producing firm) and deemed to be particularly high, the government may feel the urge to step in with the provision of subsidies. ▶

Maillac/REA

Compulsory catalytic converters: trade barrier or environmental necessity?

Subsidies represent one of the key areas of discussion in the Uruguay Round of trade negotiations. Current GATT rules do not proscribe production subsidies *per se*, as they do not necessarily distort trade. But if such subsidies are large and paid to industries operating in the international market, they could very well give a competitive edge to the products of a particular firm or sector, thus causing short- or long-term trade distortions. Firms in other countries or sectors might then request similar subsidies or countervailing duties to neutralise the trade effects, thus setting off a spiral of government intervention and, very possibly, trade friction.

Might firms then be inclined to transfer production abroad in order to escape more stringent environmental regulations at home? So far there is little evidence of it. Indeed, firms which can anticipate new environmental regulations may even gain a competitive edge in producing and exporting pollution-control equipment and technology. It has been reported that the West European market for pollution-control equipment–everything from advanced waste-disposal technology to catalytic converters–is worth more than $30bn a year and that more than a million people in the EC are employed in this market and related services.[2]

This growth may partly offset the short-term competitive disadvantage that some countries may suffer in trade in pollution-intensive goods and services. Yet not all will manage to raise the capital required to re-equip their industries. Developing countries, in particular, may find themselves at a serious disadvantage if they have to bring their environmental standards into conformity with those of OECD countries within a short period.

□ □

Finding a balance between environmental control policies and liberal trade obligations is not always easy, and is likely to become more difficult in the future. A number of issues will therefore have to be examined:

- In what circumstances are trade-related actions justified and effective in preventing damage to the environment?
- How does one determine which–indeed, whether–environmental standards are 'legitimate'?
- To what extent should account be taken of the popular pressure that governments may be under in some cases to adopt standards without adequate scientific assessment of their efficiency and consultation with other trade partners?
- Once environmental actions have been taken by governments, will they not be difficult to modify, even if protectionist effects can be demonstrated?

The GATT and other international agreements may provide some guidelines on tackling these questions. For instance, the GATT Code on Technical Barriers to Trade provides disciplines for the use and harmonisation of standards so they do not create unnecessary barriers to trade. In addition, the OECD in 1972 drew up a list of Guiding Principles concerning International Economic Aspects of Environmental Policies for member countries.[3] One of these principles, the 'Polluter-Pays Principle' was created specifically to prevent trade distortions as a result of different methods for financing pollution abatement.

But it will take further cases to establish how effective these instruments are in ensuring a balance between environmental concerns and trade. Governments might ultimately feel they should, on the one hand, set up new instruments to generate transparency in the use of standards and, on the other, establish more accurate criteria for determining 'necessity' in environmental terms. And, finally, an increase in worldwide harmonisation of environmental standards would prevent the unavoidable problems created by the existence of diverse national and regional regulations. ■

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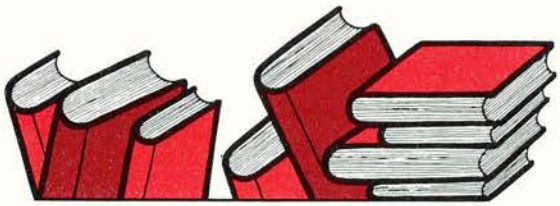

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Maintaining a Stable Economic Environment

Economic activity in the OECD area has been buoyant.[1] In the first half of 1989, output grew at an annual rate of 4% for the fifth successive semester; early in the year inflation picked up somewhat, but it has generally stabilised or even receded marginally since late spring. Growth appears to have slowed recently; OECD projections for 1990 and 1991 envisage steady OECD expansion, at just under 3%, with OECD inflation also steady, at around 4½%.

This assessment may prove to be too cautious: the forces underlying the buoyant developments since 1987 may reflect more substantial and far-reaching structural changes than embedded in the projections. If so, trend economic growth would be stronger than implied by the figures here, and in the near term productive investment growth might not slow as much as envisaged.

Sustained, satisfactory economic performance, however, cannot be taken for granted. There are concerns, risks and pressures in a number of quarters.

- Even if inflation has been stabilised–and at a lower rate than some observers had feared–it is high enough to be of concern. There is little margin left to absorb shocks, and stronger inflationary pressures than those projected by the OECD could yet emerge, in particular from wage settlements.
- Output growth could slow more than foreseen in the short run, especially given uncertainty about the effects of monetary tightening over the past year or so.
- Even if the growth projections presented here are realised, the rate of unemployment is likely to be stabilised only for the OECD area–and to remain high in a number of countries.
- Little further adjustment of the current-account imbalances of the three largest countries appears to be in store. In a number of other countries, external deficits are large or threatening to become so.
- Concern about high real interest rates raises questions about the adequacy of private saving and underlines the importance of reducing competition for these funds arising from government deficits.
- There are questions about how well financial markets are allocating saving flows among investment alternatives and about the stability of these markets, the more so in the light of the stock-market disturbances in October.
- The prospects for an improvement in the situation of indebted countries remain in the balance.
- The future of the multilateral trading system is still uncertain, as the Uruguay Round enters a critical phase against a background of strong protectionist sentiment.

Favourable current conditions must be fully exploited by policy-makers in order to deal with these threats to sustained progress and provide a stable economic environment for private initiative. This is largely a matter of governments moving ahead along lines to which they have already committed themselves: continuing to direct monetary policy firmly against any tendency for inflation to rise in the short term and towards price stability over the medium term; carrying fiscal consolidation further in a number of countries; stepping up the momentum of structural reform; and pursuing co-operative solutions to problems, both within the OECD and with non-member countries.

A new and important opportunity for economic co-operation has emerged as dramatic political changes in Eastern Europe have created new aspirations and possibilities for economic reform. The challenge here is daunting, but the potential benefits are far-reaching both for the countries concerned and for the world economy.

The key economic policy issues facing governments as they seek to foster economic stability and progress are considered here under six headings: inflation; progress in fiscal consolidation; external imbalances; the costs and benefits of exchange-rate stability; reinforcing international co-operation; and Eastern Europe.

Inflation

There are three reasons not to be complacent about an outlook of relatively stable inflation, around 4½% in the OECD area as a whole, with rates that are significantly higher in some countries (Table 1). Two are concerned with the medium-term, the third involves a more immediate risk.

First, governments and central banks have stated their medium-term inflation objectives to be approximate price stability or, alternatively, a rate of inflation low enough not to be a significant factor in the economic and financial decisions of firms and households. By either standard, current rates of inflation in most countries are significantly above the goal. If central banks and governments wish to maintain the credibility of their commitments to price stability, it will be necessary to continue with monetary restraint and, in some countries, to press harder. If current inflation rates are tolerated for too long, they will increasingly come to be seen as a floor, and expectations will be set accordingly. The ultimate costs of bringing down inflation would then be higher.

Second, the experience of the 1960s and early '70s showed that a policy of accommodating the prevailing inflation rate leads to irregular but cumulative upward drift. This may result from meeting short-run liquidity requirements at times of stress, while not exerting pressure in more tranquil periods to reclaim lost ground. The public in many countries may be tolerant of something close to present rates of inflation–if they remain steady–despite the distortions involved. Nonetheless, it would be risky not to stick to the goal of price stability in setting monetary policy. Otherwise any adverse supply shock or miscalculation in meeting apparent short-term liquidity requirements is likely to put inflation on a track toward rates widely seen to be intolerable. By the time this point was reached, the cost of reducing inflation once again would have become very high.

Third, wage pressures could intensify more than projected over the coming year. Workers understandably expect to share in the gains from higher growth in recent years (Table 2), and employers could be less resistant to wage demands at a time of buoyant sales and healthy profits. But accelerating nominal wages would erode the conditions which have underpinned growth in recent years. Even if nominal wage settlements only reflected productivity increases and inflation, the current momentum of inflation would be sustained. By contrast, if hourly wage settlements were more moderate, real wage gains in line with economy-wide productivity performance would still be forthcoming, provided that competitive forces in markets and overall monetary restraint discipline firms' price mark-ups over costs. In this case, there would be an easing of inflationary momentum and a better climate for growth-sustaining investment. There are also sectoral considerations which would come into play if wage settlements passed on the full productivity gains in sectors where such gains are relatively large owing to innovation and investment. In this case, there would be a risk of higher inflation as workers in other sectors sought to keep up. On the other hand, wage moderation in high-productivity sectors would allow for lower prices, an expansion of markets and higher employment (Table 3) in these sectors, as well as for stronger economy-wide increases in real income.

To reduce immediate inflationary risks on the wage front, it seems critical for policy in coming months to set an appropriate context for wage negotiations. This requires clear commitment by authorities (i) to anti-inflation monetary policies, supported by a suitable orientation of fiscal policy, and (ii) to making markets more competitive, in particular by actions to reverse both subsidies and border protection and to strengthen competition policies. At the same time, governments should resist firmly more generous wage settlements in the public sector than labour-market conditions warrant.

Progress in Fiscal Consolidation

OECD governments have made solid progress in reducing budget deficits, and in a number of countries budgets are now in surplus. Budget-deficit reductions are contributing to financial stability, and to freeing funds for private investment. By 1991, the area-wide general government deficit is projected to be less than 1% of GNP, down from 4% at the beginning of the decade. During the past two years or so, deficit reduction has been helped by unexpectedly strong growth. In most countries, however, progress has been less than it might have been, given the rate of growth. In part, this reflects the lowering of tax rates as one dimension of structural reform, but in many countries some of the revenue bonus from faster growth has gone to increase spending.

In a number of countries deficits are projected to continue at high levels as a percentage of GNP–in the double-digit range in Italy and Greece. Further progress seems especially important in countries with sizable current-account deficits. More generally, to settle for small deficits–or even a balance–in general government accounts during a period of strong economic activity may be insufficiently ambitious. Deficits would tend to rise and could become large once again if economic activity were to slow and, in the longer term, most countries have to provide for growing social-security entitlements as their populations age. Failure to build social-security reserves, or using them to offset continuing large deficits in other government accounts, would mean sharply higher tax burdens in the future.

Achieving a sound fiscal position is not just a matter of getting the budget balance right: there is also the question of how far public programmes, and the expenditures associated with them, are effectively meeting social and economic goals. OECD governments are closely concerned with the volume and composition of public spending and the efficiency of

Table 1

PRIVATE CONSUMPTION DEFLATORS IN THE OECD AREA[1]

percentage changes; seasonally adjusted at annual rates

	1988	1989	1990	1991	1989 II	1990 I	1990 II	1991 I	1991 II
United States	3.9	4.5	4.5	4.7	3.7	4.7	4.7	4.7	4.7
Japan	0	1.7	2.7	2.6	2.6	2.8	2.7	2.6	2.6
Germany	1.2	3.3	2.6	2.6	1.0	3.2	3.1	2.4	2.4
France	2.7	3.4	2.9	2.7	3.1	2.9	2.8	2.7	2.6
Italy	4.9	6.1	5.5	5.2	5.5	5.6	5.4	5.2	5.2
United Kingdom	5.0	5.7	6.5	5.2	7.2	6.7	5.5	5.1	5.1
Canada	3.7	4.8	4.8	6.9	5.0	4.7	4.7	9.2	4.7
Total of above countries	2.8	3.9	4.0	4.0	3.6	4.2	4.1	4.1	3.9
Other OECD countries[2]	6.6	7.9	7.6	6.7	8.1	7.7	7.1	6.8	6.2
Total OECD	3.3	4.4	4.5	4.4	4.2	4.7	4.5	4.5	4.2
Four major European countries	3.1	4.4	4.1	3.7	3.8	4.3	4.0	3.6	3.6
OECD Europe	4.2	5.6	5.2	4.7	5.1	5.4	5.0	4.7	4.4
EEC	3.3	4.6	4.3	3.9	4.1	4.5	4.2	3.9	3.8
Total OECD *less* the United States	3.0	4.4	4.5	4.2	4.5	4.6	4.3	4.3	3.9

	1989	1990	1991
Austria	2.8	3.0	3.1
Belgium	3.3	3.2	3.0
Denmark	4.8	3.5	3.3
Finland	6.2	6.1	5.1
Greece	14.1	16.8	16.0
Iceland	21.1	16.0	..
Ireland	3.5	4.0	4.0
Luxembourg	3.4	3.1	2.9
Netherlands	1.5	2.2	2.0
Norway	4.7	4.5	4.4
Portugal	12.8	10.5	9.0
Spain	6.7	6.3	6.0
Sweden	6.6	8.2	7.7
Switzerland	3.3	3.5	3.2
Turkey	75.0	63.0	50.0
Total of above countries	8.1	7.7	6.8
Australia	7.0	7.3	6.2
New Zealand	5.7	5.3	4.5
Total of above 17 countries	7.9	7.6	6.7

1. Aggregates were computed on the basis of 1987 GNP/GDP weights expressed in 1987 US dollars.
2. Half-yearly data must be interpreted with care.

public agencies, and almost everywhere reforms of various kinds are under way or in prospect. A possible new element here is a scaling-down of defence expenditure as a result of the reduction in East-West tensions. This would give scope for lower volumes of public spending or for a shift in its composition towards kinds of expenditure which may be increasing in importance–such as responding to educational, infrastructural or environmental concerns.

External Imbalances

Long-standing current-account imbalances–the deficit of the United States and the surpluses of Japan, Germany and a few small countries–are projected to continue at roughly 2% or more of GNP (Table 4). Deficits in the United Kingdom, Canada, Australia, Spain, Portugal, Greece, Finland and Sweden are also of this relative magnitude or higher–although for most of these countries they are of more recent vintage. While there is no reason for policies to aim at a given level for the current account in the short term, or even for a current account close to zero, on average, over the long term, external imbalances are not a matter of indifference. Taking a short-term view, current inflation rates are generally higher in those countries with sizable deficits than in those with small deficits or surpluses. This observation suggests that excessive demand pressures are contributing to current-account deficits, so that monetary and fiscal restraint is called for in the countries concerned. But the persistence–or threatened persistence–of external imbalances points to the necessity of considering the medium-term forces at work. Three medium-term perspectives on current-account imbalances are considered here.

First, current-account surpluses and deficits can be viewed as reflecting imbalances between domestic saving and investment. In this context, a distinction has come to be made between 'good' surpluses and deficits and 'bad' ones. 'Good' surpluses and deficits reflect flows of funds between countries where saving and investment behaviour is undistorted and farsighted, so that these flows result in a more efficient international allocation of capital, with benefits to both surplus and deficit countries. 'Bad' surpluses and deficits are those that reflect saving and investment patterns that are distorted by large fiscal imbalances, or by structural features of economies such as tax systems, subsidies, protection, regulatory constraints, and the saving disincentives inherent in social-security programmes. This perspective suggests that policies should seek to eliminate structural distortions and to establish neutral fiscal positions over the medium-term. But neutrality in this sense does not necessarily imply a balanced budget by the usual-cash flow measures. Account must be taken of longer-term demographic pressures on social-security systems, government net investment, and revenues derived from depletion of natural resources.

This focus on fiscal and structural distortions to saving and investment points to the necessity of eliminating the fiscal deficits now prevailing in many, though not all, of the countries in current-account deficit. This perspective also suggests the importance of closely examining the possibility that private saving and investment

Table 2

GROWTH OF REAL GNP/GDP IN THE OECD AREA[1]

seasonally adjusted at annual rates (%)

	Share in total OECD 1987	change from previous year				change from previous half-year				
		1988	1989	1990	1991	1989 II	1990 I	1990 II	1991 I	1991 II
United States	36.0	4.4	3.0	2.3	2.5	2.5	2.2	2.4	2.5	2.5
Japan	19.0	5.7	4.8	4.5	4.3	4.8	4.3	4.5	4.3	4.0
Germany	8.9	3.6	4.3	3.2	3.1	1.1	4.0	3.9	2.7	2.9
France	7.0	3.4	3.4	3.1	2.8	3.5	3.0	2.9	2.8	2.7
Italy	6.0	3.9	3.3	3.2	3.0	3.8	3.0	3.0	3.2	2.9
United Kingdom	5.4	4.2	2.3	1.3	1.9	1.4	1.2	1.5	2.1	2.1
Canada	3.3	5.0	2.9	2.0	2.2	2.8	1.6	1.9	2.3	2.5
Total of above countries	85.8	4.5	3.5	2.9	2.9	3.0	2.9	3.0	2.9	2.9
Other OECD countries[2]	14.2	3.3	3.8	2.6	2.6	3.2	2.5	2.5	2.6	2.6
Total OECD	100.0	4.4	3.6	2.9	2.9	3.0	2.8	2.9	2.9	2.8
Four major European countries	27.4	3.8	3.4	2.8	2.8	2.4	3.0	3.0	2.7	2.7
OECD Europe	39.8	3.7	3.5	2.8	2.7	2.7	2.8	2.8	2.7	2.7
EEC	34.3	3.7	3.6	2.9	2.8	2.6	3.0	3.0	2.8	2.8
Total OECD *less* the United States	64.0	4.3	3.9	3.2	3.1	3.3	3.2	3.3	3.1	3.1
Industrial Production:										
Major seven countries	–	6.3	4.3	3.1	3.1	3.1	3.1	3.1	3.1	3.1
Total OECD	–	6.0	4.2	3.1	3.1	3.1	3.2	3.1	3.1	3.1

	Share in total OECD 1987	% change from previous year			
		1988	1989	1990	1991
Austria	0.9	4.2	4.2	3.0	2.6
Belgium	1.1	4.3	4.5	3.0	2.7
Denmark	0.8	−0.4	1.4	1.3	2.0
Finland	0.7	5.2	4.6	2.2	1.1
Greece	0.4	4.0	2.3	1.9	1.7
Iceland	0	−1.3	−2.7	−1.0	..
Ireland	0.2	1.2	4.4	3.3	3.3
Luxembourg	0	5.2	4.2	3.4	3.0
Netherlands	1.7	2.9	4.2	2.9	3.0
Norway	0.7	2.3	5.8	2.2	2.1
Portugal	0.3	4.1	4.8	4.2	3.7
Spain	2.3	5.0	4.9	4.1	3.8
Sweden	1.3	2.5	2.1	1.2	0.9
Switzerland	1.4	3.0	3.0	2.4	2.3
Turkey	0.5	3.4	1.3	3.2	4.3
Total of above countries	12.4	3.4	3.7	2.7	2.6
Australia	1.6	3.5	4.1	1.9	2.5
New Zealand	0.3	−1.0	2.2	2.5	2.6
Total of above 17 countries	14.2	3.3	3.8	2.6	2.6

1. Aggregates were computed on the basis of 1987 GNP/GDP weights expressed in 1987 US dollars.
2. Half-yearly data must be interpreted with care.

flows may be distorted in both surplus and deficit countries; one issue here is raised by differences across countries in taxation of corporate and investment income.

Yet the distinction between 'good' and 'bad' external positions does not provide a set of fully operational rules by which particular situations can be judged. The elimination of distortions to saving and investment decisions and the establishment of fiscal neutrality are guiding principles only. The nature and extent of distortions are to some extent debatable–the more so in the case of saving and investment decisions, when considerations of intergenerational equity are brought in, as most people would think they should be. Nor is there any guarantee, in a world where irreducible uncertainties prevail, that a given pattern of surpluses and deficits will not give rise to problems, even in the absence of identifiable distortions.

A second perspective, complementary to that of 'good' and 'bad' external positions, is that of sustainability. Unsustainable current-account deficits and surpluses and their interaction with exchange rates have often been a key factor in forcing abrupt changes of policies.[2] The first indicator of sustainability, stability of portfolio composition, is based on an assessment of the demand for new dollar assets that would be forthcoming if the dollar share of private-sector portfolios remained constant as the value of these portfolios increased. The second is the ratio of US net foreign debt to exports–one of several possible measures of debt sustainability. These considerations are applicable more widely, although the United States, being a key-currency country, is a somewhat special case.

A current-account surplus or deficit may be sustainable if the corresponding capital flows are consistent with relatively stable portfolio shares. By this standard, a US deficit of the present magnitude seems sustainable, or nearly so. But this judgement rests on incomplete data, and on the assumption that the supply of dollar-denominated instruments issued by countries other than the United States remains relatively low. On the side of the demand for dollar instruments, it may be that the strength of capital flows into the United States is partly attributable to less fully developed financial markets elsewhere, and to this extent, portfolio behaviour may be distorted and sustaining a 'bad' deficit. More fundamentally, stable portfolio shares for claims on a deficit country depend on confidence being maintained in that country's economic and financial soundness. Otherwise, capital flows would dry up, leading to pressure on interest-rate differentials and exchange rates. Such pressures would force adjustment. This risk is still relevant today.[3]

The second operational indicator, debt sustainability, is closely related to the 'good' deficit/'bad' deficit distinction and to the risk of a loss of confidence. A country in which foreign indebtedness is high in relation to exports–or in which this ratio seems likely to deteriorate steadily–is susceptible to difficulties in meeting debt-ser-

Table 3
UNEMPLOYMENT IN THE OECD AREA
national definitions

	1988	1989	1990	1991	1989 II	1990 I	1990 II	1990 I	1990 II
Unemployment rates (%)[1]									
United States	5.5	5.2	5.4	5.5	5.3	5.4	5.4	5.5	5.5
Japan	2.5	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Germany	7.9	7.3	7.1	7.2	7.2	7.1	7.2	7.2	7.2
France	10.0	9.5	9.3	9.2	9.4	9.3	9.3	9.2	9.2
Italy	12.2	12.0	12.2	12.3	12.0	12.1	12.2	12.3	12.3
United Kingdom	8.2	6.5	6.6	6.9	6.3	6.5	6.7	6.9	7.0
Canada	7.8	7.5	7.6	8.0	7.5	7.6	7.7	7.9	8.1
Total of above countries	6.4	5.9	6.0	6.1	5.9	5.9	6.0	6.0	6.1
Other OECD countries	9.4	9.0	8.9	8.8	9.0	8.9	8.9	8.9	8.8
Total OECD	7.0	6.6	6.6	6.6	6.5	6.6	6.6	6.6	6.7
Four major European countries	9.4	8.7	8.6	8.8	8.6	8.6	8.7	8.7	8.8
OECD Europe	9.6	9.0	8.9	8.9	8.9	8.9	8.9	8.9	8.9
EEC	10.3	9.5	9.3	9.3	9.4	9.3	9.3	9.3	9.3
Total OECD *less* the United States	7.7	7.2	7.2	7.2	7.1	7.1	7.2	7.2	7.2
Unemployment (millions)									
North America	7.7	7.5	7.8	8.1	7.5	7.8	7.9	8.0	8.2
OECD Europe	16.8	15.9	15.8	16.0	15.7	15.8	15.9	16.0	16.0
Total OECD	26.8	25.4	25.8	26.3	25.4	25.7	25.9	26.2	26.4

%	1988	1989	1990	1991
Austria	3.6	3.4	3.3	3.2
Belgium	10.0	9.1	8.3	8.0
Denmark	8.6	9.4	9.5	9.2
Finland	4.6	3.5	3.6	4.1
Greece	7.7	7.8	8.6	9.2
Iceland	0.9	1.7	2.0	..
Ireland	16.7	16.0	15.3	14.8
Luxembourg	1.5	1.4	1.4	1.4
Netherlands	8.3	7.6	7.0	6.5
Norway	3.2	5.1	4.9	4.6
Portugal	5.8	5.4	5.3	5.5
Spain	19.5	17.3	16.1	15.3
Sweden	1.6	1.3	1.7	2.0
Switzerland	0.7	0.6	0.6	0.7
Turkey	9.8	10.7	11.1	11.4
Total of above countries	9.7	9.4	9.2	9.1
Australia	7.1	6.2	6.5	6.7
New Zealand	6.0	7.2	7.2	7.0
Total of above 17 countries	9.4	9.0	8.9	8.8

1. As percentage of labour force.

vice obligations over the longer term. This could mean that investment is being allocated inefficiently, or that saving is too low–that is, total domestic consumption, public and private, is on a course that cannot be maintained. Even for a country with a substantial net foreign creditor position and hence no serious problems of debt management, a continuing rapid rundown of this position may signal an unsustainable consumption path.

The United States has moved in the 1980s from a sizable net foreign creditor position to a significant debtor position; and the debt-to-export ratio continues to rise in the projections here, which are at the optimistic end of the spectrum. Significant further adjustment of the trade balance would be required for this ratio to be stabilised within the range in which indebtedness has proved manageable without difficulty by other countries. The large current-account deficits of the other countries mentioned above also appear to require reduction to be sustainable, although for some recent deficits it may be premature to make judgements about the medium-term prospects for their being corrected without major policy adjustments.

These indicators of sustainability point to patterns of external imbalances that warrant policy attention. While they tend to focus attention on deficits, unsustainable deficits that are large in the aggregate may also reflect that policies in surplus countries are required to promote adjustment. There is no *a priori* reason to presume that the underlying problems lie with policies of deficit countries alone and not also with those of surplus countries. Nor would the costs of reaching the limits of stable private financing be borne only by debtor countries; the ensuing enforced adjustment would be costly for all. Thus, sustainability is a relevant perspective from which to view the overall pattern of current-account surpluses and deficits.

There may also be a less quantifiable and more political sense in which large imbalances–particularly large trade deficits and corresponding foreign investment flows–could be unsustainable. Public opinion typically considers these as signs that something is not right. A problem arises when those seeking insulation from foreign competition are able to exploit this public concern in order to bolster their case. While there may be good reasons to be concerned about large, sustained imbalances, protectionist trade and investment policies would be an ineffective as well as damaging response. What is called for is a set of policies to address underlying problems of national saving and competitiveness, so as to achieve external balances that are sustainable, and are seen as such by both financial markets and a wider public.

A third perspective is that of competitiveness. This is central to the current-account adjustment process. In order to achieve durable adjustment, expenditure shifts between tradable and non-tradable goods and services, and between home and foreign goods and services, must accompany changes in domestic saving/investment balances. Relative cost and price competitiveness conditions–that is,

Table 4

CURRENT BALANCES OF OECD COUNTRIES

$ billion; seasonally adjusted at annual rates

	1988	1989	1990	1991	1989 II	1990 I	1990 II	1991 I	1991 II
United States	−126.6	−122	−118	−124	−120	−117	−119	−122	−125
Japan	79.6	61	61	69	58	59	63	67	70
Germany	48.5	61	71	76	63	70	72	74	78
France	−3.6	−4	−4	−4	−4	−4	−4	−4	−4
Italy	−5.6	−12	−13	−14	−12	−13	−14	−13	−15
United Kingdom	−25.9	−32	−30	−26	−33	−31	−29	−27	−25
Canada	−8.4	−14	−14	−15	−13	−13	−14	−14	−15
Total of above countries	−41.8	−62	−46	−38	−60	−48	−45	−40	−37
Other OECD countries	−8.4	−23	−26	−33	−23	−26	−25	−30	−36
Total OECD	−50.2	−85	−72	−71	−83	−75	−70	−70	−73
Four major European countries	13.5	13	24	32	15	23	26	30	34
OECD Europe	16.1	6	11	10	9	10	12	11	10
EEC	15.7	5	11	13	7	11	12	13	13
Total OECD *less* the United States	76.4	36	46	52	37	42	50	52	53

	1988	1989	1990	1991
Austria	−0.3	−0.2	0	−0.1
Belgium-Luxembourg	3.5	3.5	3.7	3.6
Denmark	−1.8	−1.6	−1.3	−1.6
Finland	−3.0	−4.2	−5.2	−5.7
Greece	−1.0	−2.5	−2.8	−2.8
Iceland	−0.2	−0.1	−0.3	−0.2
Ireland	0.7	0.5	0.4	0.4
Netherlands	5.1	5.0	4.6	3.7
Norway	−3.7	1.8	3.2	3.6
Portugal	−0.6	−1.0	−1.6	−2.0
Spain	−3.7	−11.4	−16.0	−20.2
Sweden	−2.5	−3.9	−4.8	−6.3
Switzerland	8.6	6.9	6.5	5.9
Turkey	1.5	0.5	0.3	0.2
Total of above countries	2.6	−6.7	−13.2	−21.6
Australia	−10.6	−16.8	−12.8	−12.0
New Zealand	−0.3	0	0.2	0.3
Total of above 17 countries	−8.4	−23.4	−25.9	−33.3

real exchange rates–have to be such as to make this possible. It was once widely thought that freely floating exchange rates would maintain appropriate competitiveness conditions; this has not proved to be the case. Rather, floating exchange rates have at times accommodated expenditure patterns associated with saving and investment imbalances of the unsustainable, even 'bad', type. This raises the question of the extent to which exchange-rate stability can and should be an objective of international policy co-operation.

Costs and Benefits of Exchange-Rate Stability

Achieving increased exchange-rate stability through international policy co-operation has, in fact, received a good deal of attention in recent years. It has been a focus of G7 policy co-ordination since the Louvre Accords in February 1987. Its importance in the EMS context has been enhanced as re-alignments have ceased to be common occurrences. A number of countries outside both of these orbits have also attached increased importance to exchange-rate stability, with some pegging their rates to a key currency or to a basket of the currencies of their main partners.

The principal benefit of exchange-rate stability–which does not necessarily imply immutable exchange rates–is reduced uncertainty in business and financial planning, which allows for more efficient investment and a fuller realisation of comparative advantage through international trade. Avoiding large swings and resulting clear misalignments of exchange rates is especially important. Trade will neither flourish nor be efficient if firms are subjected to large, capricious fluctuations in their competitiveness. Nor is support for an open trading system likely to hold up if the efficiency gains from it are not evident and the market position of firms producing tradable goods is highly unstable. A second potential benefit is the avoidance of possible vicious circles of depreciation, price increases and wage pressures, which can undermine domestic inflation objectives.

The pursuit of exchange-rate objectives may also entail costs. Seeking to maintain exchange rates at positions that prove to be uncompetitive–or over-competitive–contributes to the development of unsustainable trade imbalances. There may also be costs if fundamental policy goals are subordinated to exchange-rate objectives–if monetary policy is diverted from achieving and maintaining price stability, or if capital controls are imposed which distort investment flows. Attempting to stabilise the currencies of countries with significantly different inflation rates might especially pose a risk for low-inflation countries. Even with monetary-policy intentions consistent with inflation objectives, intervention in the exchange market could lead to excessive monetary ease if it were to involve drawings on credit lines between central banks on a scale which strained the means to sterilise them. Yet these costs may be small and relatively short-lived when competitiveness and relative inflation rates are reasonably in line, when monetary co-operation is firmly established, and when expectations are stabilised by a commitment to a clear exchange-rate objective that is viewed as realistic.

The experience of the EMS suggests that, even with some divergences of inflation rates and competitiveness, it is poss-

ible to achieve a high degree of exchange-rate stability for considerable periods without having to tolerate swings in interest-rate differentials so large and erratic as to affect domestic stability. Financial-market volatility seems to have been damped, and not simply deflected from exchange rates to interest rates. EMS commitments have also reinforced domestic policies aimed at moving toward uniformly low inflation rates, which in turn have made nominal exchange-rate stability increasingly feasible. On the other hand, attempting to stabilise an exchange-rate without a clear and convincing commitment to continue such a policy may do little to temper erratic capital flows. Attempts to hold steady the exchange value of the pound sterling for a period in 1987–88 may thus have resulted in exchange-market pressures being diverted to domestic UK interest rates rather than being reduced. Monetary conditions became excessively easy, accommodating an acceleration of inflation which gave rise to the subsequent necessity of exerting strong monetary restraint.

While, in part, EMS experience is unique to that institution, it does bear on the question of how far intensified co-operation among the major countries to achieve more explicit and more ambitious exchange-rate stabilisation objectives might reduce the volatility of both interest rates and exchange rates. The stronger the commitment to exchange-rate stability, the bigger would be the necessity of a supportive orientation of fiscal policies and for flexibility–in international trade, domestic production structures and labour markets–to maintain competitive balance and promote adjustment. Thus, structural policies to improve flexibility would raise the degree of realistic ambition with respect to exchange rates. In this connection, the closer market integration and liberalisation envisaged in the EC 1992 programme is supportive of the commitment to a high degree of exchange-rate stability within the EMS.

The importance of action over the full range of policies in underpinning increased exchange-rate stability can be seen in the present situation. In 1989, authorities have been concerned with keeping the dollar from appreciating to rates that would clearly make US products uncompetitive. The costs of efforts to limit dollar appreciation have not seemed excessive, partly because co-ordinated intervention has proved to be an effective measure for relieving short-run pressures and turning back speculative surges. More fundamentally, monetary-policy actions aimed at damping the dollar have not so far been out of line with domestic requirements. But the room for manœuvre was small: if dollar strength had persisted through the autumn, the scope for further monetary-policy adjustment to counter it would have been limited, especially the scope for easing US monetary policy.

The potential for unwelcome pressures on monetary policies could be reduced through more vigorous actions to correct conditions that make for destabilising pressures on exchange rates. Such actions, which would contribute more generally to healthier economies, include elimination of the US Federal budget deficit; structural reforms in surplus countries that would make financial markets in their currencies more liquid, and hence a more attractive alternative to dollar placements; and other structural reforms, in deficit and surplus countries alike, that would improve the balance of saving and the efficient allocation of investment across countries and between tradable and non-tradable sectors. In Japan, these include regulatory changes–especially in the distribution and other service sectors–to improve market access further and to facilitate the expansion of activity in non-tradable sectors. In Germany, the dependence of growth and investment on export performance could be reduced through the elimination of regulations and barriers to entry which now have significant adverse effects on flexibility, efficiency and entrepreneurship in a wide range of non-tradable service activities.

The degree of ambition currently feasible with respect to exchange rates among the major currencies is limited not only by prevailing inflation differentials, but also by large uncertainties about the implications for long-term competitiveness of the current pattern of real exchange rates. Nevertheless, maintaining a stable economic environment will require that no less than the present degree of importance be attached to exchange-rate stability and to the domestic economic policies that are required to support it. Over the medium term, the strengthening of commitments in this respect, as further progress is made toward price stability, fiscal consolidation and structural flexibility, could serve to reduce the overall volatility of the financial environment.

Reinforcing International Co-operation

International economic co-operation has been strengthened progressively over a wide range of issues and policy areas in the second half of the 1980s, following a period in which co-operative approaches took a back seat to efforts directed at domestic problems and concerns. In turn, enhanced co-operation has made an important–though unquantifiable–contribution to the strength of OECD activity since 1987, in part by helping to underpin the revival of private-sector confidence and hence the buoyancy of investment. Satisfactory economic performance in the years to come will require a continuation of the current commitment to co-operation, and quite probably its reinforcement. Experience suggests that this cannot be taken for granted. Strains are inherent in such a process; and co-operation could become more complex because the circles of both players and problems are widening.

The touchstone of effective international co-operation is, of course, implementing commitments. Going beyond this to reinforce co-operation implies intensifying action in a number of specific ways:

• As to exchange-market stability, the above discussion puts the case for maintaining at least the current extent of ambition in this domain. A particular challenge is to ensure that co-operation here is not sapped by 'battle fatigue', given the inevitability of difficult periods. Full implementation of fiscal policy commitments and closer co-operation in dealing with systemic financial-market issues would further domestic objectives, while at the same time it would reduce the burden on monetary instruments in achieving exchange-market objectives.

• Co-operation among OECD countries in respect of structural reform is well under way. Within the OECD, the process of surveillance in this domain is being strengthened along the lines proposed by the Economic Policy Committee in its Report to Ministers on *Surveillance of Structural Reform*[4] and endorsed by Ministers. The requirement is to step up the momentum of structural reform and to extend the range of actions. Progress in undertaking reforms that command broad support, such as tax reductions, has to be matched in areas where issues are more contentious, such as scaling back industrial subsidies and achieving a progressive and concerted reduction of agricultural support. Increased transparency of policies and of their effects is important–both to strengthen the case for reform and as an aid to monitoring progress. In agriculture, for example, the producer and consumer subsidy equivalents calculated by OECD have sharpened perceptions of the nature and extent of problems.

• As to trade policies, there are obvious dangers from the forms of interventions in which a number of member countries are increasingly engaged. One main source of danger is the tendency to define and address trade problems bilaterally, through direct country-to-country negotiations. A second is the increasing resort in a number of OECD countries to anti-dumping actions which in effect, though not in declared intention, are instruments of discriminatory protection. Against this background, the challenge to OECD countries is to achieve clear and substantial progress in the negotiations that are now under way in the Uruguay Round. Failure would have serious consequences for the open multilateral trading system, which in turn would be damaging to the prospects for both growth and stability. In this respect, 1990 is crucial.

• New forms and measures of international co-operation are likely to be required in respect of other problems which extend across national frontiers–most strikingly in environmental issues.

• Opportunities have opened up in relations with non-OECD developing countries. OECD member countries are moving to a second stage of discussions with the dynamic Asian economies. New initiatives backed by governments of OECD countries aim to deal with the problems of heavily-indebted countries. Financial arrangements are being made and policy programmes are being adopted in several countries, where they have promise of bearing fruit in terms of improved functioning of the economy and more secure debt-servicing.

Eastern Europe

Events in Eastern Europe and the Soviet Union are moving too rapidly to identify the specific directions economic developments will take. One by one, these countries have been committing themselves to move from state-planned systems to more market-oriented economies, although the economic reforms currently envisaged differ widely in scope. They face massive challenges along this road. In some of these countries, classic stabilisation problems are signalled by high or hyper-inflation, large budget deficits which have been largely monetised, heavy external debt, and continuing current-account deficits in convertible currencies. Where these conditions exist, action is urgently required.

Stabilisation measures and some critical structural reforms will have to proceed in parallel–success will depend on each reinforcing the other. In pursuing market-oriented reforms, Eastern European countries will to some extent be in new territory: the possible transition paths from state-planned to market-oriented economy are not clearly marked, and finding one will require analysis of processes outside the range of past experience. Nonetheless, lessons–both positive and negative–might be drawn from the experience of OECD countries in managing market economies and undertaking structural reforms.

One such set of lessons emerges from the progress made by OECD countries in structural reform over the last decade. The importance of reform was recognised at more or less the same time in a number of OECD countries and this led to a process in which mutual support and active international co-operation facilitated the implementation of reforms. Correspondingly, transition to more market-oriented economies could be given impetus and direction by a common approach which involved a number of Eastern European countries. Western countries, and international organisations including the OECD, are assisting Eastern European countries in the process of transition; but success will mainly depend on the ability of these countries to identify an appropriate set of solutions, and to commit themselves to the specific lines of policy action involved.

1 December 1989

1. **OECD Economic Outlook,** No. 46, OECD Publications, Paris, December 1989.

2. Some past episodes of this kind are treated in **Why Economic Policies Change Course,** OECD Publications, Paris, 1988.

3. It has been a fairly constant theme in the **OECD Economic Outlook,** from 1984 onwards.

4. OECD Publication, Paris, June 1989; available free of charge from the OECD Client Services Unit, Paris.